MERGER ANTITRUST LAW

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Class 23 (November 18): Vertical Mergers (Unit 14)

We will spend Classes 23 and 25 on vertical mergers. Vertical mergers occur within the chain of manufacture and distribution, such as the merger between an input manufacturer and a final goods producer or between a wholesaler and a retailer. More generally, however, the theories of anticompetitive harm that apply to vertical mergers equally can apply to any merger between companies producing complementary products.

Theories of anticompetitive harm for vertical mergers fall into two general categories: exclusionary effects and coordinated effects.

Exclusionary effects. The canonical exclusory effect is *foreclosure*. For example, a lithium battery manufacturer acquires a lithium mine that premerger supplied several battery manufacturers. After the acquisition, the combined company refuses to sell lithium to competitor-battery manufacturers. The idea is that in foreclosing its downstream competitors by refusing to sell them a critical input, the combined company will disadvantage its competitors—in the extreme, drive them out of business—and reap anticompetitive gains as the customers of the foreclosed competitors shift over to the combined firm.

As this example reveals, whether this foreclosure is anticompetitive depends on several factors:

1. Is the foreclosed product "essential" to competitors of the merged firm?
2. Can the foreclosed competitors purchase the input in adequate quantities and at premerger prices from third-party suppliers?
3. Does the combined firm have the profit-maximizing incentive to foreclose its competitors?

If the product is not "essential" to the manufacturing process, manufacturers can substitute other inputs and there will be no harm to competition. Likewise, if competitor-manufacturers can obtain the input from third-party suppliers without suffering a competitive disadvantage, there will be no harm to competition. Finally, even if the combined firm has the ability to foreclose its competitors, it may not have the incentive to do so: foreclosing competitors means lost profits from the sales that otherwise would have been made, and it may be that the anticompetitive gains from foreclosure do not outweigh the losses. The key here is the number of sales that would shift from the competitors to the combined firm if the combined firm refused to sell its competitors the input.

Short of complete foreclosure, the combined firm could simply increase the prices of the input it sells to its downstream competitors. This theory, developed primarily by Professor Salop and known as *raising rivals' costs* (RRC), has become the primary theory of vertical anticompetitive harm. Raising rivals' is not as extreme as complete foreclosure, but for the same reason it may in the combined firm's profit-maximizing interest to increase its prices to rivals even if it is not in the firm's interest to completely foreclose its competitors. An acquisition that provides the combined firm with the incentive and ability to raise its rivals' costs with the likely effect of increasing market price violates Section 7.

While the example above deals with input foreclosure/RRC, the same theories of anticompetitive harm apply to output foreclosure. For example, say that a particular distribution channel is critical for manufacturers to reach a particular group of important customers. An incumbent manufacturer acquires the distribution channel and either forecloses its manufacturer-rivals from the channel or increases their costs to access the channel. If, as a result, the competitor-manufacturers are disadvantaged in their ability to compete against the combined firm with the likely result that pries to consumers will increase, the acquisition violates Section 7.

Coordinated effects. A second type of anticompetitive harm that may result from a vertical merger is coordinated effects. There are four common varieties of coordinated effects that can arise from a vertical merger:

1. *Elimination of a disruptive buyer*: The acquisition by an incumbent supplier of a disruptive buyer that was destabilizing efforts by suppliers could increase the postmerger likelihood or effectiveness of coordination interaction.
2. *Elimination/disciplining of new disruptive competition*. When the merged firm can price discriminate in the prices its charges its rivals, it can target particular new entrants that threaten to disrupt seller coordination by refusing to deal with those entrants or materially raising their input prices.
3. *Facilitation of tacit coordination through greater firm homogeneity*. As related markets become more structured as vertical silos through vertical integration, firms become more alike (homogeneous), which causes their incentives to align and so facilitates horizontal coordination
4. *Anticompetitive information conduits*. In a market that is otherwise conducive to oligopolistic coordination *except* that information on which to coordinate is not readily available, the vertical merger provides a mechanism for obtaining this information. The classic case is where supplier prices are not transparent, so suppliers make vertical acquisitions of purchasers, enabling them to see their competitors' prices.

Coordinated effects theories are usually employed, if at all, to support a challenge to vertical mergers for foreclosure or raising rivals' costs. The exception is vertical mergers that act as anticompetitive information conduits, which the agencies have challenged without also alleging foreclosure or raising rivals' costs.

Efficiencies. At least since the early 1980s, most vertical mergers are regarded as efficiency-enhancing and unlikely to raise competitive concerns. Firms at different levels of production and distribution may need to coordinate to design, manufacture and distribute their products. Vertical mergers may increase the efficiency of this process by improving communication, sharing more information, and harmonizing the incentives of the merging firms. Moreover, vertical integration can reduce costs by eliminating a markup on the sale of the upstream input to the downstream operation (so-called *double marginalization*), which in many cases are likely to be passed on consumers, at least in part, in the form of lower prices.

Enforcement and relief. Since the 1980s, the enforcement agencies have challenged very few vertical mergers. The Supreme Court last heard a vertical merger case in 1972.[1] Until recently, the last adjudicated vertical case ended in 1979, when the Second Circuit denied enforcement to an FTC challenge.[2]

In the interim, the agencies have challenged several vertical mergers. Since the principal harm of vertical merger is foreclosure/RRC and the agencies were willing to accept behavioral consent decrees requiring the merged firm to deal with rivals postmerger on fair, reasonable, and nondiscriminatory terms, all of these challenges were resolved by consent decree.[3]

Things changed dramatically in the Trump administration, when then-Assistant Attorney General Makan Delrahim took the position that the Division would no longer accept behavioral consent relief. At the time, AT&T was seeking to acquire Time Warner in a deal that closely matched the earlier Comcast/NBC Universal combination and that everyone (including the merging parties) believed would be resolved through an analogous consent decree. When the Division refused to accept the proffered consent decree, the parties put the Division to its proof in court. The Division lost.

The reading. The reading materials are extensive, but I am going to cut them down considerably. First, read the class notes (slides 1-51) for more background. Second, read Jonathan Sallet's speech to the ABA on vertical mergers (pp. 4-15), which is an excellent introduction to the theories of anticompetitive harm in vertical mergers.

If we had more time, I would ask you to read the materials on the Vertical Merger Guidelines (pp. 16-68), but now I will only ask you to skim them. The Department of Justice and the FTC jointly issued the VMG during the last year of the Trump administration. Almost immediately after Lina Khan became FTC chair in the Biden administration, which gave the Democrat commissioners a voting majority, the FTC withdrew from the guidelines. The statements and dissents accompanying the guidelines' issuance and subsequent FTC withdrawal make for fascinating reading. From a good government perspective, it is also interesting that the FTC did not issue its own replacement vertical merger guidelines or give any other guidance as to how it would analyze vertical mergers and that the VMG are still effective at the DOJ.

GE/Avio is a conventional vertical foreclosure case (pp. 70-83). The materials are short, but you can skip them. I will review what you need to know about the case in class.

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1 Ford Motor Co. v. United States, 405 U.S. 562 (1972) (Ford/Autolite).

2 Fruehauf Corp. v. FTC, 603 F.2d 345 (2d Cir. 1979), *denying enforcement*, *In re* Fruehauf Corp., 91 F.T.C. 132 (1978).

3 *See, e.g.*, United States v. Comcast Corp., 808 F. Supp. 2d 145 (D.D.C. 2011) (Comcast/NBC Univeral); United States v. Google Inc., No. 1:11-cv-00688 (D.D.C. Oct. 5, 2011) (Google/ITA); United States v. United Techs. Corp., 946 F. Supp. 2d 135 (D.D.C. 2013) (UTC/Goodrich); United States v. Monsanto Co., No. 1:07-cv-00992, 2008 WL 5636384 (D.D.C. Nov. 6, 2008) (Monsanto/Delta & Pine Land); United States v. Charter Commc's, Inc., No. 1:16-cv-00759-RCL (D.D.C. Sept. 9, 2016); *In re* General Elec. Co., F.T.C. 255 (2013) (GE/Avio); *In re* Pepsico, Inc., 150 F.T.C. 231 (2010) (Pepsi/PBG); *In re* Coca-Cola Co., 150 F.T.C. 520 (2010) (Coca-Cola/CCE); Press Release, U.S. Dep't of Justice, Comcast Corporation Abandons Proposed Acquisition of Time Warner Cable after Justice Department and the Federal Communications Commission Informed Parties of Concerns (Apr. 24, 2015) (Comcast/Time Warner Cable); Press Release, U.S. Dep't of Justice, Lam Research Corp. and KLA-Tencor Corp. Abandon Merger Plans (Oct. 5, 2016) (Lam/KLA).

This brings us to *AT&T/Time Warner*. You may skim or skip the usual introductory materials (pp. 85-119). Read the DOJ's press release (pp. 120-21), but you may skip the complaint (pp. 122-144). AT&T's public relations response to the complaint is interesting in its approach and well worth the time to read the five pages.

The opinion is where you need to spend some real time. Judge Richard Leon's opinion is a model for how district court judges should write opinions: it is scholarly in approach, heavily into the facts, applies the case law with common-sense extensions of horizontal merger precedent to vertical mergers, is likely to serve as a model for courts when analyzing future vertical mergers, and carefully designed to be reversal-proof if any appeal is taken. The DOJ made some serious strategic and tactical mistakes in the way it tried the case and we can talk about those in class.

We will make it only through the opinion up to Judge Leon's treatment of the expert evidence pp. 150-257), but read this with care.

Please email me if you have any questions. See you in class!