**MERGER ANTITRUST LAW**

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Tuesdays and Thursdays, 3:30-5:30 pm
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## Class 21 (November 10): Potential and Nascent Competition Mergers (Unit 14)

We will spend the next three classes on nonhorizontal mergers, that is, mergers between firms that are not incumbent competitors of one another. There are two types of nonhorizontal mergers that attract attention in modern U.S. enforcement: potential competition mergers and vertical mergers.

This unit examines potential competition mergers. Theories of anticompetitive harm premised on the elimination of potential rivalry through acquisition come in three related but distinct variants.

The first theory, known as the *actual potential competition doctrine*, looks directly at the elimination of possible near-term future rivals through their acquisition before they can enter the market as independent competitors. The idea here is that, in the absence of the acquisition, the potential entrant would have entered the market and its entry would have improved the competitive performance of the marketplace. Under this theory, the acquisition is anticompetitive because, on a forward-looking basis, it eliminates future rivalry and makes the market less competitive than it would have been in the absence of the transaction. The elimination of actual potential competition is the most commonly invoked theory of potential competitive harm.

The second theory, known as the *perceived potential competition doctrine*, looks at actions incumbent firms in the market currently may be taking to discourage firms they perceive as potential future entrants from entering the market. Under this theory, incumbent firms (unilaterally) take actions that increase the level of competitive activity—such as keeping prices low—which reduces the returns from operating in the market and hence decreases the attractiveness of entry. The harm arises when the perceived potential entrant is acquired, negating the incentive for incumbent firms to keep prices low or take other actions to discourage entry, and, as a result, prices in the market increase. This theory has all but been eliminated from the antitrust enforcement toolkit for lack of situations where it may apply.

A third variant of potential competition theory emerged in the last years of the Trump administration and is continuing to be pressed by the Biden administration. Under the *nascent competition theory*, an actionable harm to competition arises when a dominant firm acquires a firm whose innovation—either in the target firm's hands or the hands of a third-party acquirer or licensee—presents a serious threat to the acquirer's dominant position. The theory is a major extension of the actual potential competition theory because it does not require the target to be a near-term entrant or even a likely entrant into the incumbent's market in the absence of the acquisition. The Biden administration enforcement agencies are actively looking for cases in which to apply the theory, especially against dominant high-tech firms.

The Supreme Court has expressly recognized the elimination of perceived potential competition as an anticompetitive harm cognizable under Section 7.[1] The Court, however, has reserved judgment on the elimination of actual potential competition.[2] Lower courts, the FTC, and the 1984 DOJ Merger Guidelines have recognized the elimination of actual potential competition as an anticompetitive harm under Section 7. With one exception, the federal enforcement agencies have not litigated a potential competition case since the 1980s, although in a number of cases they have alleged the elimination of actual potential competition in complaints predicting consent settlements. The one exception is FTC v. Steris Corp.,[3] an actual potential competition case that the FTC lost for failure to show that the target was a probable potential entrant into the relevant market. Although the agencies have filed several complaints in recent years alleging that the elimination of nascent competition violates Section 7 (if not Section 2 of the Sherman Act), no court has adjudicated the theory on the merits, so it remains judicially untested.

**Eliminating actual potential competition**

An actual potential competitor is a firm that does not currently compete in the relevant market but would enter sometime in the future, either de novo or through a "toehold" acquisition of a small, competitively insignificant incumbent firm. If, however, the actual potential entrant merges with a significant incumbent firm, its incentives to enter the market independently disappear, and the market will lose that measure of additional competition that the near-term future new entry would have entailed.

Although the target company is usually the putative actual potential entrant, the theory equally applies when the acquirer is the putative entrant. The latter situation occurs when the acquirer has a "make or buy" decision and chooses to buy rather than make.

Given this concept, several conditions are required for anticompetitive harm to result from the elimination of an actual potential entrant:

1. *Non-competitiveness*. The relevant market in which the anticompetitive effect may occur must be operating noncompetitively prior to the acquisition. If the market is operating competitively, new entry cannot improve the competitive performance of the market.
2. *Uniqueness*. The putative potential entrant must be somewhat unique in its incentives and ability to enter the relevant market. If there are numerous other similarly situated potential entrants, eliminating one through acquisition is unlikely to affect the long-run level of competition in the market. The conventional wisdom is that the agencies are unlikely to challenge a transaction under the actual potential competition doctrine if the entry advantages ascribed to the putative potential entrant are shared by three or more other firms.
3. *"Available, feasible means" of procompetitive entry*. The putative potential entrant must have the means of entering the market in the near future in a way that could probably improve the competitive performance of the target market. Courts recognize two

[1] United States v. Marine Bancorporation, Inc., 418 U.S. 602, 639-40 (1974); United States v. Falstaff Brewing Corp., 410 U.S. 526, 533-34 (1973); *see* FTC v. Procter & Gamble Co., 386 U.S. 568, 581 (1967).

[2] *See* United States v. Marine Bancorporation, Inc., 418 U.S. 602, 625, 639 (1974); United States v. Falstaff Brewing Corp., 410 U.S. 526, 537-38 (1973).

[3] 133 F. Supp. 3d 962 (N.D. Ohio 2015).

procompetitive entry alternatives: de novo entry and "toehold" entry. For de novo entry to qualify as an "available, feasible means" of procompetitive entry, any barriers to entry into the market must not be so high to make entry difficult and hence unlikely. For a toehold acquisition to qualify as an "available, feasible means" of procompetitive entry: (a) toehold firms must exist in the target market that, if acquired, would provide a viable avenue to developing a significant market presence; and (b) such firms must be available for acquisition, presumably on objectively reasonable terms.

4. *Incentive*. But for the acquisition, the putative potential entrant must have a sufficient incentive in addition to the ability to enter the market using one of the above means to make entry in the near future likely. Evidence of intent to enter may be objective, but subjective intent reflected in regular course of business documents or management testimony is usually the most compelling.

5. *Procompetitive effect*. Assuming the potential entered the market in the absence of the acquisition, its entry must materially improve the competitive performance of the market.

The actual potential competition theory has not fared well in the courts. The usual problem is that the courts find that the putative potential entrant has failed to make a sufficiently concrete decision to enter the market in the near future in the absence of the acquisition. Although testimony by the potential entrant's executives that they have not decided to enter the market by itself is somewhat suspect (given their support of the acquisition), the evidence usually also shows a lack of the planning or the commitment of resources necessary to enter the market in the near term. The evidence also frequently shows a business case that entry would be unprofitable, or at least too risky to prudently attempt, and that the putative potential entrant has other opportunities to pursue that promise greater and less risky financial returns.

The "near future" is not well-defined in the case law. The conventional wisdom is that entry should be likely within two years but for the acquisition. In some situations, however, courts may apply the actual potential entry doctrine where the potential entrant is committing the necessary resources and on a well-defined path to enter the market, but regulatory approvals are likely to delay entry beyond two years. The prime example is the entry of pharmaceutical firms into new drugs requiring lengthy clinical trials for FDA approval.

Fashioning an adequate remedy in an actual potential case can be difficult. In many cases, there may be no remedy short of divesting the incumbent operating business. In other cases, however, it may be possible to create actual entry by a viable competitor by divesting the assets of the potential entrant. For example, when Actavis sought to acquire Warner Chilcott, the FTC alleged that the transaction would eliminate actual potential competition against three Warner Chilcott-branded pharmaceutical products since Actavis would be the first in the absence of the transaction to enter into the manufacture and sale of a generic competitor.[4] As a remedy, the Commission accepted a consent order that required Actavis to divest all of its rights and assets relating to its generic versions of the drugs to Amneal Pharmaceuticals, a New Jersey-based generic pharmaceutical company.[5] At the time, Amneal marketed 65 products and maintained an

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[4] Complaint ¶¶ 8-10, 12(b)-(c), *In re* Actavis, Inc., No. C-4414 (F.T.C. issued Sept. 27, 2013) (settled by consent order).

[5] Decision & Order, *In re* Actavis, Inc., No. C-4414 (F.T.C. issued Sept. 27, 2013); *see* Analysis of Agreement Containing Consent Orders To Aid Public Comment, *id*.

active product development pipeline. The idea was that Amneal had the ability and incentive to "step into the shoes" of Actavis in developing the generic versions and entering the market with these products once it obtained FDA approval. Actavis was also required to supply generic versions of two of the products to Amneal for two years, which Amneal could extend at its option for up to two additional one-year terms.[6]

**Eliminating perceived potential competition**

A perceived potential competitor is a firm not currently selling in the market that incumbent firms regard as "on the wings" of the market, that is, ready, willing, and able to enter the market as a new independent participant but waiting because the financial returns on entry are not sufficiently attractive. The idea behind the perceived potential entrant doctrine is that incumbent firms recognize this threat of entry and the likely harm to them individually if entry occurs. With this recognition, the incumbent firms then act "more competitively" than they would in the absence of this threat to keep the financial returns on entry low and continue to discourage the potential entrant from actually entering. If, however, the perceived potential entrant merges with a significant incumbent firm in the market, the perceived potential entrant essentially becomes a "member of the club" and ceases to be a competitive threat, allowing incumbent firms to cease their endeavors to discourage the firm's independent entry by keeping the market more competitive. In this sense, eliminating a perceived potential entry through acquisition is anticompetitive because the acquisition removes the procompetitive force exerted by the threat of independent entry.

Many of the necessary conditions for an anticompetitive effect to arise from the elimination of perceived potential rivalry are closely related to the conditions of the actual potential competition doctrine. These conditions reflect the fact that firms are unlikely to be perceived as potential entrants unless they are actually likely potential entrants.

1. *Non-competitiveness*. For the elimination of perceived potential competition to have any anticompetitive effect, the market must be susceptible to coordinated interaction. An oligopolistic market structure is sufficient to satisfy this condition.
2. *Perception as a likely potential entrant*. Incumbent firms must perceive the firm as a likely potential entrant.
3. *Uniqueness*. Incumbent firms must regard the perceived potential entrant as somewhat unique in its incentives and ability to enter the relevant market. If there are numerous other similarly situated potential entrants in the minds of incumbent firms, the elimination of one through acquisition is unlikely to affect the long-run level of competition in the market. The conventional wisdom is that the agencies are unlikely to challenge a transaction under the actual potential competition doctrine if the entry advantages ascribed to the putative potential entrant are shared by three or more other firms.

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[6] For a related remedy, see Complaint ¶¶ 10, 12(b), *In re* Novartis AG, No. C-4364 (F.T.C. issued July 16, 2012) (alleging the elimination of actual potential generic competition against Solaraze, a branded drug sold by Fougera that is used to treat actinic keratosis), and Decision & Order, No. C-4364 (F.T.C. issued July 16, 2012) (consent decree requiring Novartis to withdraw from a marketing arrangement with Tolmar for a forthcoming generic version of Solaraze, return all rights in the generic version to Tolmar, and precluding Fougera from pursuing patent infringement litigation against Tolmar with respect to its generic product).

4. *Incumbent reaction to the threat of entry*. Incumbent firms must be shown to be responding to the perceived threat of entry by lowering their prices, improving their product quality, or engaging in some other procompetitive activities to discourage the entry of the perceived potential entrant.
5. *Anticompetitive effect*. It must be in the profit-maximizing interest of incumbent firms to cease some or all of their procompetitive entry-deterring conduct in the wake of the acquisition to the detriment of competition in the market.

Ironically, although the Supreme Court has recognized the elimination of perceived potential competition as a valid theory of anticompetitive harm, the agencies have used the theory rarely (if at all) since 1980. There is no remedy for the elimination of perceived potential competition short of enjoining the transaction.

Read the class notes to get some more background on the theories of perceived and actual potential competition (slides 3-12). I will give you an overview in class of some of the cases in which consent decrees have been entered on the actual potential competition theory. To keep the reading materials contained, I have given you only the *Steris* case, the only litigated potential competition case since the 1980s (pp. 4-48).

**Eliminating nascent competition**

In recent years, reformers have been agitating for the antitrust laws to do something about well-entrenched monopolies, especially in high-tech industries. This has resulted in a focus on so-called "nascent competitors." A "nascent competitor" is a firm that can potentially threaten a dominant firm's position at some time in the future. The threat usually resides in the nascent competitor's development of a new technology or product that could possibly shift share away from the dominant firm.

The actual potential competition doctrine requires, among other things, that (1) but for the acquisition, the putative potential entrant would have sufficient incentive and ability to make entry in the market likely in the near future, and (2) assuming entry occurred, it must have a reasonable probability of materially improving the competitive performance of the market.

By their nature, "nascent competitors" almost always fail to satisfy these requirements. At the time of the acquisition, the nascent competitor may not be actively considering entering the market with a product competitive with the acquiring dominant firm. Even if the nascent competitor is considering entering the market—or selling itself or licensing its technology to a third party that would enter the market—entry may be more distant than in "the near future." And even if entry is contemplated in the near future, the technological and commercial success of entry—and the competitive impact of entry—may be highly speculative.

To deal with the failure of the actual potential competition doctrine as currently interpreted by the courts to deal with nascent competitors, some commentators have suggested that the government enforcement agencies and other challengers allege a Section 2 monopolization or attempted monopolization violation in addition to a Section 7 claim. The idea is that an acquisition by a firm with monopoly power of a nascent competitor that could threaten its monopoly is an actionable exclusionary act to maintain the incumbent's monopoly. No court to date, however, on the application of Section7 or Section 2 on this theory.

First, read the slides on nascent competitors (slides 13-23) to get some more background. Then read the materials on the DOJ's challenge to the Visa proposed acquisition of Plaid (pp. 50-81).

The case is not a pure nascent competitor case since, at least according to the DOJ's complaint, Plaid had indicated that it would enter with a product that could undermine Visa's market position in credit cards.[7] But what makes the case interesting are the concerns expressed by Visa management about the nascent competitive threat Plaid posed if Visa did not acquire it, either on its own or, perhaps more concerning, in the hands of another acquirer. The case squarely raises the issue of what the enforcement agencies and the courts should do when there is substantial evidence that the acquisition was partly motivated by a desire to keep the target out of the hands of another acquirer to suppress possible future competition.

**A postscript: Meta/Within**

On July 27, 2022, the FTC, after a none-month HSR second request investigation and a 3-2 vote, filed a complaint in the Northern District of California under FTC Act § 13(b) seeking a preliminary injunction blocking the proposed acquisition by Meta Platforms, Inc. of Within Unlimited, Inc. until the conclusion of an administrative trial on the merits.[8]

Meta, the company formerly known as Facebook, is the leading developer of virtual reality ("VR") devices and apps, including the Oculus Quest VR headset, through its Reality Labs division. Under CEO Mark Zuckerburg, Meta spent $36 billion on Reality Labs (for an operating loss of $30.7 billion) from January 1, 2019, to September 30, 2022.[9]

Within, a privately owned company founded in 2014, creates products, original content, formats, proprietary software, and tools for virtual and augmented reality entertainment, fitness, and learning. Its flagship product, *Supernatural*, is a complete fitness subscription service exclusively for the Oculus Quest 2 VR headset. Supernatural offers over 800 fully immersive VR workouts, each set to music and located in a virtual setting such as the Galapagos Islands or the Great Wall of China. It is the leading VR dedicated fitness app. The complaint alleges that the VR dedicated fitness app market is highly concentrated, although it does not allege (at least in the public version) that the market is operatively noncompetitively.

The FTC's amended complaint alleges that the acquisition, if consummated, would substantially lessen competition in the national market for VR dedicated fitness apps in violation of Section 7.[10] The complaint's principal theory of anticompetitive harm is that the acquisition eliminates the possibility that Meta would enter into VR dedicated fitness apps through other

[7] The DOJ's complaint is surprising light on the allegations that Plaid was contemplating entry. This suggests that something else was going on here. What do you think it might be?

[8] Amended Complaint for a Preliminary Injunction Pursuant to Section 13(b) oftThe Federal Trade Commission Act, FTC v. Meta Platforms, Inc., No. 3:22-cv-04325 (N.D. Cal. filed Oct. 7, 2022; original complaint filed July 27, 2022). For the major papers in the case, see here.

[9] Grace Dean, *Meta Has Pumped $36 Billion into Its Metaverse and VR Businesses since 2019*, BusinessInsider.com (Oct. 29, 2022). As of the close of the market on November 4, 2022, Meta stock has lost 73% of it value compared to its closing price on December 31, 2021.

[10] The complaint also alleges that the acquisiton, if consummated, would violate Section 5 of the FTC Act. But there is no indication that the Section 5 extends beyond Section 7 and incorporates a Section 2 violation. *See* Am. Compl. ¶ 14 ("On August 11, 2022, the Commission found reason to believe that the Acquisition would substantially lessen competition in violation of Section 7 of the Clayton Act, 15 U.S.C. § 18, and Section 5 of the FTC Act, 15 U.S.C. § 45.").

means, which the complaint alleges is reasonably probable but for the acquisition. The harm then is the elimination of Meta's potential competition into VR dedicated fitness apps.

This theory of anticompetitive harm is a major extension beyond what current law recognizes under the actual potential competition theory of anticompetitive harm since it fails to allege facts making a plausible claim that that (1) the VR dedicated app fitness market is operating noncompetitively, (2) Meta is one of the few firms positioned to enter the VR dedicated fitness app market in the near future, (3) Meta was developing or had plans to develop a competing dedicated fitness app absent the acquisition, or (4) Meta's entry, if it occurred, would make the VR dedicated fitness app market more competitive.

The Meta/Within complaint is the only effort to date by the Biden administration to significantly extend antitrust law beyond its current boundaries. It is worth careful attention.

Read the FT's press release announcing the enforcement action (pp. 83-85) and Meta's response to it (pp. 86-88). Then read the amended complaint (pp. 89-115). Finally, read the Defendants' Reply in Support of Motion to Dismiss the Amended Complaint (pp. 115-36). It is sufficiently self-contained and provides an excellent treatment of actual potential competition theory.

As always, email me if you have any questions.