MERGER ANTITRUST LAW

LAWJ/G-1469-05
Georgetown University Law Center
Fall 2023

Tuesdays and Thursdays, 11:10 am – 1:10 pm
Dale Collins
wdc30@georgetown.edu
www.appliedantitrust.com

Class 22 (November 14): Vertical Mergers (Unit 15)

We will spend Classes 22 and 23 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 from higher prices (due to less competition) do not outweigh the losses from the foreclosed sales that the company otherwise would have made.

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' costs is not as extreme as complete foreclosure, but for the same reason it may be 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 the incentive and ability to raise its rivals' costs with the likely effect of increasing market price violates Section 7.

In both complete foreclosure and raising costs to rivals, the combined firm's conduct will be governed by whether its incremental profit gains from the higher prices outweigh its incremental profit losses from the lost foreclosed sales.

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 consumer prices will increase, the acquisition violates Section 7.

Coordinated effects. Coordinated effects are the second type of anticompetitive harm that may result from a vertical merger. Four common varieties of coordinated effects can arise from a vertical merger:

1. *Elimination of a disruptive buyer*: The acquisition by an incumbent supplier of a disruptive buyer that premerger 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 better aligns their profit-maximizing incentives and so facilitates horizontal coordination.
4. *Anticompetitive information conduits*. In a market otherwise conducive to oligopolistic coordination *except* that information on which to coordinate is not readily available, a vertical merger can provide a mechanism for obtaining this information. In the canonical case where supplier prices are not transparent, a supplier's vertical acquisition of a distributor that purchases from all suppliers allows the merged firm to see its 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.[1]

Efficiencies. At least since the early 1980s and continuing until recently, the enforcement agencies regarded most vertical mergers as efficiency-enhancing and unlikely to raise

[1] *See, e.g.*, Merck & Co., 127 F.T.C. 156 (1999) (consent order settling complaint that Merck's acquisition of Medco, a pharmacy benefit manager that purchases drugs from all of Merck's competitors, would be an anticompetitive information conduit).

competitive concerns. Firms at different levels of production and distribution often 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 so-called *double marginalization*. Double marginalization is the distortion caused by the successive markups of independent firms in a distribution channel. In theory, vertical integration eliminates the incentive to markup the product of the upstream firm to the downstream firm (since it is a wash on the combined profits of the merged firm), which can reduce consumer prices, increase output, *and* increase aggregate profits. The idea that the elimination of double marginalization increases the vertically integrated firm's profit led to a presumption in antitrust circles that vertically integrated firms always eliminate double marginalization, so there was no need to present affirmative proof of the elimination. But there is good reason to believe that because of the nature of compensation systems within large firms, vertical integration may not fully eliminate—or eliminate at all—double markups. From an enforcement perspective, the Trump and Biden antitrust enforcement agencies have been skeptical that vertical mergers eliminate double marginalization. If the merging parties claim the elimination of double marginal efficiency as an efficiency in an agency investigation, they will have to prove it in the circumstances of their merger. Moreover, although not yet tested in court, under the *Baker Hughes* burden-shifting paradigm the merging parties in their rebuttal case should bear the burden of production on elimination of double marginalization in Step 2, not the plaintiff's prima facie case in Step 1.[2]

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.[3] Until recently, the last adjudicated vertical case ended in 1979, when the Second Circuit denied enforcement to an FTC challenge.[4]

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.[5]

---

[2] The class notes review double marginaliztion on slides 14-20. If you understand the general idea explained in the text and look at the Marginal Revolution University's YouTube video, there is no need for you to go further than slide 14. If you want more, however, look at the graph and numerical example on slides 15-20 and the math in the appendix (slides 46-52).

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

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

[5] *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); General Elec. Co., F.T.C. 255 (2013) (GE/Avio); *In re* Pepsico, Inc., 150 F.T.C. 231 (2010) (Pepsi/PBG); 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,

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 in a rather spectacular fashion.

Since AT&T/Time Warner, the enforcement agencies have filed complaints against five vertical mergers.

Sabre/Farelogix, another Trump administration action, was a vertical case that the DOJ tried as a horizontal case, presumably to avoid the problems it faced in AT&T/Time Warner.[6] The DOJ brought the case in the District of Delaware, again presumably to avoid the AT&T/Time Warner precedent (if not the AT&T/Time Warner judge). The DOJ lost the case, no doubt in large part because of the confusion it caused by trying an easily explained vertical case as an almost impossible-to-explain horizontal case.

UnitedHealthcare/Change, a Biden administration action filed in the District of Columbia, was tried more sensibly as a straightforward vertical case.[7] Again, the DOJ lost. We will study this case in Class 25.

Microsoft/Activision, a Biden administration FTC Section 13(b) action filed in the Northern District of California, sought to preliminary enjoin Microsoft's $69 billion acquisition of Activision Blizzard.[8] Microsoft manufactures the Xbox line of video game consoles. It also operates Xbox Game Studios, a collection of developers to create first-party titles, and Xbox Game Pass Cloud Gaming, Xbox's cloud gaming streaming service. Activision develops and publishes video games for consoles, PCs, and mobile devices, including the blockbuster first-person shooter video game franchise *Call of Duty*. The district court rejected the FTC's argument that it only had to show that the acquisition "is likely to increase the ability *and/or* incentive of the merged firms to foreclose rivals" from access to Call of Duty to make out a prima facie case of anticompetitive effect for lack of authority and as inconsistent with judicial precedent requiring a showing of a reasonable probability of anticompetitive effect.[9] Instead, the court that

---

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).

[6] United States v. Sabre Corp., 452 F. Supp. 3d 97 (D. Del. 2020), *vacated*, No. 20-1767, 2020 WL 4915824 (3d Cir. July 20, 2020). The DOJ appealed. Although the DOJ failed to obtain an injunction, the United Kingdom's Competition and Markets Authority (CMA) did block the deal. When Sabre and Farelogix terminated their merger agreement in light of the U.K. decision, the DOJ moved in the court of appeals to vacate the lower court's decision. The Third Circuit granted the motion "because Sabre Corporation mooted the parties' dispute by terminating its acquisition of Farelogix." 2020 WL 4915824 (citing U.S. Bancorp Mortg. Co. v. Bonner Mall P'ship, 513 U.S. 18, 25 (1994) (explaining that vacatur is merited "when mootness results from unilateral action of the party who prevailed below")). Copies of the major filings in the case may be found here.

[7] United States v. UnitedHealthcare Group Inc., 630 F.Supp.3d 118 (D.D.C. Sept. 21, 2022). Copies of the major filings in the case may be found here.

[8] FTC v. Microsoft Corp., No. 23-CV-02880-JSC, 2023 WL 4443412 (N.D. Cal. July 10, 2023). Copies of the major filings in the case may be found here.

[9] *Id*. at *12 (emphasis added).

the FTC must show that the merged firm "(1) has the ability to withhold *Call of Duty*, (2) has the incentive to withhold *Call of Duty* from its rivals, and (3) competition would probably be substantially lessened as a result of the withholding."[10] While the court held that Microsoft would have the *ability* to foreclose competitors from *Call of Duty*, it found "overwhelming evidence" of the combined firm's *lack of incentive* to do so.[11] In making this finding, the court relied, among other things, on the following evidence:

1. Immediately upon the merger's announcement, Microsoft committed to maintaining *Call of Duty* on its existing platforms and even expanding its availability, and contacted its competitors about entering into a new agreement to extend Activision's obligation to ship Call of Duty.
2. The deal plan evaluation model presented to the Microsoft Board of Directors to justify the Activision purchase price relies on PlayStation sales and other non-Microsoft platforms post-acquisition.
3. Microsoft witnesses, including its CEO, consistently testified there are no plans to make *Call of Duty* exclusive to the Xbox.
4. No internal documents, emails, or chats contradicted Microsoft's stated intent not to make *Call of Duty* exclusive to Xbox consoles.
5. *Call of Duty's* cross-platform play is critical to its financial success, creating an incentive to leave *Call of Duty* on PlayStation.
6. Microsoft anticipates irreparable reputational harm if it forecloses Call of Duty from PlayStation.
7. The FTC has not identified any instance where an established multiplayer, multi-platform game with cross-play has been withdrawn from millions of gamers and made exclusive.
8. The FTC's key economic expert. Dr. Robin Lee, did not dispute the evidence of Microsoft's lack of an economic incentive.

Finding insufficient evidence of incentive to foreclose, the court held that the FTC failed to show a likelihood of success on the merits and denied the FTC's motion for a preliminary injunction. The FTC is pursuing an appeal of the decision to the Ninth Circuit, although the Court of Appeals denied the FTC's emergency motion for an injunction pending appeal.[12]

---

[10] *Id*. at *13.

[11] *Id*. at *15.

[12] *See* Order, FTC v. Microsoft Corp., No. 23-15992 (9th Cir. Oct. 14, 2023) (denying emergency motion for an injunction pending appeal). Notwitstanding the lack of any antitrust obstacle to closing the transaction in the United States, the UK Competition and Markets Commission found the transaction violate UK antitrust law and issued a draft order that would enjoin the acquision. UK Competition and Markets Authority, The Microsoft And Activision Merger Inquiry: [Draft] Order 2023 (May 19, 2023); *see* UK Competition and Markets Authority, Anticipated Acquisition by Microsoft of Activision Blizzard, Inc.: Final Report (Apr. 26, 2023). Microsoft subsequently restructured the transaction, with Activision, prior to the merger's closing, to divest the global cloud streaming rights to all existing console and PC games, and those produced over the next fifteen years, to an independent gaming company. The CMA opened a new merger inquiry into the restructured deal, and the parties settled, allowing the acquisition to close. *See* UK Competition and Markets Authority, Anticipated Acquisition by Microsoft Corporation of Activision Blizzard (excluding Activision Blizzard's non-EEA cloud streaming rights): Decision on Consent under the Final Order (Oct. 12, 2023). On the day the CMA order was issued, Microsoft closed

The remaining two vertical mergers challenges are both FTC cases: Illumina/Grail, filed in 2021, and Lockheed/Aerojet, filed in 2022. In Illumina/Grail, the ALJ found for the parties, the full Commission reversed and found a violation, and the case is currently on appeal in the Fifth Circuit.[13] In Lockheed/Aerojet, after the Commission issued an administrative complaint, the parties abandoned the deal and the Commission dismissed the administrative complaint.[14]

The reading. The reading materials are extensive, but I am going to cut them down considerably. First, read the class notes (slides 1-45) for more background.[15] 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-appointed 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 on 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.

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. 122-44). 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 meaningful 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 these pages with care.

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

---

on the Activision acquisition. *See* Microsoft Closes $69 Billion Activision Blizzard Deal, Reuters. Com (Oct. 13, 2023). As of November 9, 2023, the FTC also was continuing its administrative proceeding against the transaction.

[13] *See* Initial Decision, Illumina, Inc., No. 9401 (F.T.C. Sept. 9, 2022) (ALJ finding for respondents), *rev'd*, Final Decision, Illumina, Inc., No. 9401 (F.T.C. Mar. 31), *petition for review pending*, Illumina, Inc. v. FTC, No. 23-60167 (5th Cir. docketed Apr. 5, 2023).

[14] *See* Complaint, Lockheed Martin Corp., No. 9405 (F.T.C. issued Jan. 25, 2022); Press Release, Lockheed Martin Corp., *Lockheed Martin Terminates Agreement to Acquire Aerojet Rocketdyne* (Feb. 13, 2022). Copies of the major filings in the case may be found here.

[15] *See supra* note 2 on reading the slides on the elimination of double marginalization.