MERGER ANTITRUST LAW

LAW 1469	Tuesdays and Thursdays, 3:30 pm – 5:30 pm
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Class 22 (November 14): Vertical Mergers (Unit 15)

We will spend Classes 22 through the end of the course 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 still 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 or otherwise harming competition 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*, the same theories of anticompetitive harm apply to *output foreclosure*. For example, suppose that a particular distribution channel is critical for manufacturers to reach a specific group of 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 it charges its rivals, the merged firm can target new entrants that threaten to disrupt seller coordination by refusing to deal with those entrants or materially raising the prices it charges them.
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 a vertical merger that acts 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

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[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 entirely 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 eliminating 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]

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[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, 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).

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 several vertical mergers.

Sabre/Farelogix, another Trump administration action filed in 2019, 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.

In *Lockheed/Aerojet*, filed in 2022 after the Commission issued an administrative complaint, the parties abandoned the deal, and the Commission dismissed the administrative complaint.[7]

UnitedHealthcare/Change, a Biden administration action filed in 2022 in the District of Columbia, was tried more sensibly as a straightforward vertical case.[8] Again, the DOJ lost. We will study this case in Class 25.

Microsoft/Activision, a Biden administration FTC Section 13(b) action filed in 2023 in the Northern District of California, sought to preliminary enjoin Microsoft's $69 billion acquisition of Activision Blizzard.[9] 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

[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] *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.

[8] 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.

[9] FTC v. Microsoft Corp., 681 F. Supp. 3d 1069 (N.D. Cal. July 10, 2023). Copies of the major filings in the case may be found here.

requiring a showing of a reasonable probability of anticompetitive effect.[10] Instead, the court that 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."[11] 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.[12] 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 relied on PlayStation sales and other non-Microsoft platforms post-acquisition.
3. Microsoft witnesses, including its CEO, consistently testified that there were no plans to make Call of Duty exclusive to 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.[13]

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[10] *Id*. at 1089 (emphasis added).

[11] *Id*. at 1090.

[12] *Id*. at 1090-97.

[13] *See* Order, FTC v. Microsoft Corp., No. 23-15992 (9th Cir. Oct. 14, 2023) (denying emergency motion for an injunction pending appeal). The appeal was argued on December 6, 2023, and remains under advisement. As of November 4, 2024, the FTC also was continuing its administrative proceeding against the transaction.

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

Illumina/Grail was filed in 2021, but it has the most recent judicial opinion. Illumina, a leading manufacturer of next-generation sequencing (NGS) platforms, reacquired Grail, a company Illumina previously owned and spun off that had developed an MCED test to detect multiple cancers from a single blood draw. The FTC challenged the acquisition, arguing it was anticompetitive because Illumina, the sole supplier of NGS platforms necessary for MCED tests, could foreclose Grail's competitors. In the administrative trial, the ALJ found for the parties, but on appeal the full Commission reversed, found a violation, and ordered Illumni to divest Grail.[14] On appeal to the Fifth Circuit, although the court of appeals held that substantial evidence supported the Commission's finding of a prima facie violation of Section 7, the court vacated the Commission's order for failure to apply the proper standard at the rebuttal stage. At issue was Illumina's "Open Offer" to supply competitors with NGS platforms under specific terms. The Fifth Circuit determined that this offer, made before the FTC's final decision, should be considered at the liability stage, specifically as part of Illumina's rebuttal to the FTC's prima facie case. However, the court found that the FTC had improperly required Illumina to prove the Open Offer would completely eliminate any anticompetitive effect rather than simply show it sufficiently mitigated those effects so that the restructured deal would not have likely substantially lessened competition.[15] The court of appeals also emphasized that, as rebuttal evidence, Illumina only had the burden of production; the Commission had the burden of persuasion on the ultimate effect on competition.[16]

The reading. The reading materials are extensive, but I am going to cut them down considerably. Please read the class notes (slides 1-45) for background material. Then, carefully review Guidelines 5 and 6 of the 2023 Merger Guidelines (pp. 57-66). If time permits, skim the 2020 and 2021 materials (pp. 5-56) for additional context. These materials trace an interesting regulatory history: The 2020 Vertical Merger Guidelines were issued jointly by DOJ and FTC near the end of the Trump administration. After Lina Khan became FTC chair during the Biden administration, giving Democrat-appointed commissioners a voting majority, the FTC withdrew

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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 on the Activision acquisition. *See* Microsoft Closes $69 Billion Activision Blizzard Deal, Reuters. Com (Oct. 13, 2023).

[14] *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), *vacated and remanded*, Illumina, Inc. v. FTC, 88 F.4th 1036 (5th Cir. Dec. 15, 2023).

[15] WDC: The court of appeals found that the FTC erred by treating the Open Offer as a remedy. Instead, the Open Offer was a rebuttal element. Had the restructuring occurred after the Commission's decision fiding the acquisition unlawful, then it would have been proper for the FTC to require proof that the restructuring completely eliminated all anticompetitive effects. However, that was not the case here. 88 F.4th at 1058-59.

[16] *Id*. at 1058 ("To be sure, Illumina's burden was only one of production, not persuasion; the burden of persuasion remained with Complaint Counsel at all times.") (citing United States v. UnitedHealth Grp. Inc., 630 F. Supp. 3d 118, 132 (D.D.C. 2022), and FTC v. Microsoft Corp., 681 F. Supp. 3d 1069, 1090 (N.D. Cal. 2023)).

The Commission never issued an opinion on remand. Two days after the Fifth Circuit issued its opinion, Illumina announced it would divest Grail. Press Release, Illumina, Inc., Illumina Announces Decision to Divest GRAIL (Dec. 17, 2023). On June 24, 2024, Illumina announced it had completed the divestiture through a spin-off as an independent public company. Press Release, Illumina, Inc., Illumina Completes the Divestiture of GRAIL (June 24, 2024). On August 15, 2024, the Commission granted a joint motion to dismiss the complaint as moot, ending the administrative litigation. Order Dismissing Complaint, *In re* Illumina, Inc., No. 9401 (F.T.C. Aug. 15, 2024).

from the guidelines. The FTC's withdrawal created an unusual situation where the 2020 VMG technically remained in effect at the DOJ while the FTC operated without formal guidelines. This state of affairs continued until December 18, 2023, when DOJ and FTC issued new joint Merger Guidelines addressing vertical mergers.

You may skim or skip the materials on the GE/Avio merger, a conventional vertical foreclosure case (pp. 69-82). 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. 84-118). Read the DOJ's press release (pp. 119-20), but you may skip the complaint (pp. 121-43). AT&T's public relations response to the complaint is interesting in its approach and well worth the time to read the five pages (pp. 144-48).

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 trying the case, which we can discuss in class.

We will make it only through the opinion up to Judge Leon's treatment of the expert evidence pp. 149-256), but read these pages with care. If you want to get ahead for Classes 23 and 24, continue reading the AT&T/Time Warner opinion. Youcan learn as much about litigating merger antitrust cases from this opinion as you can from any other opinion we study in the course.

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