MERGER ANTITRUST LAW

LAW 1469
Georgetown University Law Center
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Class 21 (November 5): Introduction to Vertical Mergers (Unit 12)

We will spend the next four classes 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 apply to any merger between companies producing complementary products.

Theories of anticompetitive harm for vertical mergers can be categorized into two general types: exclusionary effects and coordinated effects. The Unit 12 class notes introduce these concepts (slides 3-6).

Exclusionary effects. The canonical vertical exclusionary effect is *foreclosure*. For example, a lithium battery manufacturer acquires a lithium mine that premerger supplied several rival battery manufacturers. After the acquisition, the combined company refuses to sell lithium to competitor battery manufacturers. The idea is that by foreclosing 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 customers of the foreclosed competitors shift to the combined firm (slide 11).

As this example shows, whether this foreclosure is anticompetitive depends on the input's importance, the availability of adequate alternatives, and the combined firm's profit-maximizing incentive to foreclose. The relevant issue is whether restricting access would materially weaken competition, not whether the input is literally indispensable.

If manufacturers can substitute other inputs without suffering a competitive disadvantage, foreclosure will not harm competition through this mechanism. Likewise, if competitor manufacturers can obtain inputs from third-party suppliers in adequate quantities and on competitive terms, competition will not be harmed. Finally, even if the combined firm can 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 from the foreclosed sales that the company otherwise would have made.

Short of complete foreclosure, the combined firm could increase the prices of the input it sells to its downstream competitors. This theory, developed primarily by Professor Steven Salop and known as *raising rivals' costs* (RRC), has become the primary theory of vertical anticompetitive harm (slide 12).[1] Raising rivals' costs is less extreme than complete foreclosure, so it may still be

[1] *See* Steven C. Salop & David T. Scheffman, *Raising Rivals' Costs*, 73 AM. ECON. REV. 267 (1983); Thomas G. Krattenmaker & Steven C. Salop, *Anticompetitive Exclusion: Raising Rivals' Costs to Achieve Power over Price*, 96 YALE L.J. 209 (1986); Steven C. Salop & David T. Scheffman, *Cost-Raising Strategies*, 36 J. INDUS. ECON.

in the combined firm's profit-maximizing interest to raise 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 prices or otherwise harming competition, violates Section 7.

In both complete foreclosure and raising costs to rivals, the combined firm's conduct depends on whether its incremental profit gains from higher prices outweigh its incremental profit losses. Before the merger, the supplier already counts upstream profits on sales diverted to any other customer it supplies. A merger changes that comparison because the upstream firm now also accounts for profits earned downstream when customers shift from disadvantaged rivals to the acquired firm. The diversion ratio measures the fraction of the rival's lost sales that the merged firm recaptures. Higher diversion and higher incremental profits on recaptured sales make foreclosure more attractive, other things equal (slide 13).[2]

The class notes illustrate this distinction with a battery-pack manufacturer, M, that supplies two lamp makers, R1 and R2, and acquires R1. Each lamp requires one battery pack. M's unit cost is $9, and its initial wholesale price is $15. R1 sells lamps for $40 and incurs $15 in other incremental costs, so M earns a $6 upstream margin and R1 earns a $10 downstream margin. Suppose a $2 wholesale-price increase to R2 reduces its purchases from 300 to 180, and 25 percent of its 120 lost sales divert to R1. The example holds R1's retail price and other costs fixed, assumes sufficient capacity, and uses the same quantity response before and after the merger (slide 14).

Before the merger, M gains $360 from the higher margin on 180 retained sales, loses $720 on 120 foregone sales to R2, and recaptures $180 in upstream profit on 30 additional sales to R1. The net change is a $180 loss. After the merger, those same upstream entries remain, but M also receives R1's $300 downstream profit on the diverted sales. The net change becomes a $120 gain. The merger therefore changes the profitability of this specified increase by $300, not by the full $480 earned upstream and downstream on diverted sales (slide 15).

The example tests a specified price increase; it does not find the optimal price or establish the merger's overall effect on competition. Diversion and contribution margins must be supported by evidence. If only 10 percent of R2's lost sales divert to R1, the same increase produces a $168 postmerger loss (slide 58). The appendix develops the profit identities and this sensitivity calculation (slides 55-59). A profitable strategy establishes an incentive to pursue it; a Section 7 case still requires evidence of likely competitive harm, including the downstream effects and any offsetting EDM benefits. The class notes distinguish the incentive calculation from the substantial-lessening-of-competition requirement (slide 16).

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 it. If, as a result, competitor manufacturers are disadvantaged in

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19 (1987); Steven C. Salop, *The Raising Rivals' Cost Foreclosure Paradigm, Conditional Pricing Practices, and the Flawed Incremental Price-Cost Test*, 81 ANTITRUST L.J. 371 (2017); David T. Scheffman & Richard S. Higgins, *Twenty Years of Raising Rivals' Costs: History, Assessment, and Future,* 12 GEO. MASON L. REV. 371 (2003).

[2] If this reminds you of recapture unilateral effects, you would be on point. The mathematics are very similar. If you understand recapture unilateral effects, raising rivals' costs should be straightforward to you.

their ability to compete against the combined firm, with the likely result that consumer prices will increase, the acquisition violates Section 7 (slide 12).

Two-level entry. A vertical merger may also make entry more difficult if a potential entrant can no longer obtain an important input or reach customers through an adequate independent distribution channel. If comparable alternatives are unavailable, the entrant may have to enter both input production and final-product production, or both manufacturing and distribution. The additional investment, scale requirements, and coordination can make entry slower, less likely, or less effective. The competitive concern is the loss of entry that would otherwise constrain incumbents. It therefore depends on the importance of the foreclosed access and the feasibility of alternatives, rather than on the fact of vertical integration alone.

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*: An incumbent supplier's acquisition of a disruptive buyer that premerger destabilized suppliers' efforts to raise prices could increase the postmerger likelihood or effectiveness of coordinated interaction (slide 17).
2. *Elimination/disciplining of new disruptive competition*. When the merged firm can price discriminate in the prices it charges its rivals, it can target new entrants that threaten to disrupt seller coordination by refusing to deal with those entrants or by materially raising the prices it charges them (slide 18).
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 tacit coordination (slide 19).
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 (slide 20).

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 an anticompetitive information conduit, which the agencies have challenged without also alleging foreclosure or raising rivals' costs.[3]

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 competitive concerns. Firms at different levels of production and distribution often need to coordinate to design, manufacture, and distribute their products. Vertical mergers may improve this process by improving communication, sharing more information, and harmonizing the merging firms' incentives.

[3] *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).

Moreover, vertical integration can change pricing incentives by eliminating so-called *double marginalization*. Double marginalization is the distortion caused by the successive markups of independent firms in a distribution channel. The retailer treats the wholesale payment, including the upstream markup, as an incremental cost and does not account for the upstream profit generated by an additional retail sale. Integration brings those profits into a joint pricing decision. Eliminating the double markup can reduce consumer prices, increase output, and increase aggregate profits even when the resource costs of production and distribution do not change (slide 21). In the class notes' single-retailer example, resource cost remains $4 per unit, but the cost relevant to retail pricing falls from $8 to $4. The consumer price falls from $10 to $8, output increases from two to four units, and combined profits rise from $12 to $16. The integrated firm still exercises market power (slide 25).

These savings are not automatic. Premerger contracts may already avoid some double marginalization, and compensation systems within large firms may prevent common ownership from fully aligning pricing incentives. If the merging parties claim the elimination of double marginalization as an efficiency in an agency investigation, they should substantiate it in the circumstances of their merger. The size of the savings, their merger specificity, and the extent to which lower incremental costs affect final prices matter. Under the *Baker Hughes* burden-shifting paradigm, defendants bear the burden of producing evidence supporting their rebuttal, while the plaintiff retains the ultimate burden of persuasion.[4]

Effects on different customers. RRC and EDM can operate at the same time. Lower incremental costs may allow the merged firm to reduce prices to its customers, while higher input prices may lead rivals to increase prices to theirs. A benefit to one group does not establish that the other group is unharmed, and a price increase to rivals' customers does not establish that there are no offsetting consumer benefits. The analysis must identify the affected customers, the magnitude and timing of the price changes, and their implications for competition in the relevant market. In *AT&T/Time Warner*, the government's expert compared predicted consumer price increases with savings from EDM. Class 23 examines the evidence underlying that comparison.

Opportunity cost and pass-through. When the upstream firm also supplies competing downstream firms, an additional sale by its acquired firm may displace upstream sales to those rivals. The forgone upstream profit is an opportunity cost of expanding the acquired firm's sales and reduces the effective EDM benefit. Pass-through is a separate step: a reduction in the cost relevant to pricing need not produce an equal reduction in the price consumers pay.

The class notes use a separate bicycle example to compare these effects (slide 26). The component's premerger wholesale price is $12 and its production cost is $5, giving a $7 markup. An additional sale by the acquired assembler also entails $1 in forgone upstream profit, so its effective input cost is $6 and the effective cost reduction is $6. At 50 percent pass-through, its consumer price falls by $3. A $1 wholesale-price increase to rival assemblers, with the same pass-through rate, raises their consumer prices by $0.50. The $1 opportunity-cost estimate

[4] The class notes review double marginalization (slides 21-28). The Marginal Revolution University's YouTube video provides additional conceptual background. The conceptual explanation, compact comparison, and opportunity-cost and pass-through example are part of the assignment (slides 21, 25-28). If you want more detail, the graph and derivation explain the single-retailer model (slides 22-24), the numerical tables and profit chart appear in Appendix 2 (slides 60-63), and the algebra appears in Appendix 3 (slides 64-70). These additional derivations, tables, and algebra remain optional.

already incorporates the relevant upstream margins and displaced sales; it should not be counted a second time (slide 27).

Weighting these price changes by baseline annual sales of 2,000 bicycles for the acquired assembler and 8,000 for its rivals gives $6,000 in savings for the former's customers and $4,000 in higher payments for the latter's customers, or a net $2,000 reduction. If the rivals' wholesale-price increase is instead $2, their consumer prices rise by $1 and their customers pay $8,000 more, reversing the net result to a $2,000 increase. These are approximations at premerger quantities, not calculations of actual postmerger spending or a complete measure of consumer welfare. Purchases may change, and the estimates do not calculate those quantity responses or their additional effects on consumers (slide 28).

Enforcement and relief. The class notes review the Supreme Court's vertical-merger decisions and their modern significance (slides 7-8). Since the 1980s, the enforcement agencies have challenged very few vertical mergers. The Supreme Court last decided a vertical merger case in 1972.[5] Until recently, the last adjudicated vertical case ended in 1979, when the Second Circuit denied enforcement to an FTC challenge.[6]

In the interim, the agencies 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 specified terms, many of these challenges were resolved by consent decree.[7]

Things changed dramatically in the first Trump administration when then-Assistant Attorney General Makan Delrahim announced a strong preference for structural relief and criticized continuing behavioral supervision. At the time, AT&T was seeking to acquire Time Warner in a deal that closely matched the earlier *Comcast/NBCUniversal* combination. The merging parties proposed behavioral protections modeled on that settlement. When the Division refused to accept the proposed resolution, the parties put the Division to its proof in court. The Division lost in a rather spectacular fashion. This policy shift did not make conduct relief legally unavailable, and the agencies' practices have not been uniform. The class notes trace this change in enforcement practice (slide 9). We will spend much of the time in this unit examining *AT&T/Time Warner*.

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

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

[7] *See, e.g.*, United States v. Comcast Corp., 808 F. Supp. 2d 145 (D.D.C. 2011) (*Comcast/NBC Universal*); 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., 156 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*). These settlements permitted the transactions to proceed subject to conditions, *but* they were not all purely behavioral. UTC/Goodrich required divestitures as well as supply and transition protections, and Monsanto/Delta & Pine Land combined divestitures with changes to licensing terms. *Comcast/NBCUniversal*, Google/ITA, Charter, *GE/Avio*, Pepsi, and Coca-Cola illustrate conduct restrictions, including access obligations or information protections. By contrast, *see* 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*).

Since *AT&T/Time Warner*, the enforcement agencies have filed complaints against several vertical mergers with mixed results:

- Commission decision finding a violation, vacated and remanded on appeal on relief
  - *Illumina/GRAIL* (FTC 2023)[8]
- Litigated losses
  - *Sabre/Farelogix* (DOJ 2020)[9]
  - *UnitedHealth/Change* (DOJ 2022)[10]
  - *Microsoft/Activision* (FTC 2023)[11]
  - *Tempur Sealy/Mattress Firm* (FTC 2025)[12]
- Abandonments after complaints
  - *NVIDIA/Arm* (FTC 2021)[13]
  - *Lockheed/Aerojet* (FTC 2022)[14]
- Settlements
  - ICE/Black Knight (FTC 2023)[15]

We will examine *AT&T/Time Warner* in Classes 22-24. In Class 24, the remedies note will place that decision alongside *Illumina/GRAIL*, *UnitedHealth/Change*, *Microsoft/Activision*, and *Tempur Sealy/Mattress Firm*.

The Guidelines. Guideline 5 of the 2023 Merger Guidelines examines mergers that may limit rivals' access to products or services they use to compete. It addresses the merged firm's ability and incentive to limit access, the significance of available substitutes, and the resulting effects on

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[8] *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, 2023), *vacated and remanded*, *Illumina, Inc. v. FTC*, 88 F.4th 1036, 1055-59, 1064 (5th Cir. 2023) (sustaining the prima facie analysis but requiring reconsideration of the Open Offer under the proper rebuttal standard). Copies of the major filings in the case may be found here.

[9] 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.

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

[11] FTC v. Microsoft Corp., 681 F. Supp. 3d 1069 (N.D. Cal. 2023), *aff'd*, 136 F.4th 954 (9th Cir. 2025). Copies of the major filings in the case may be found here.

[12] FTC v. Tempur Sealy Int'l, Inc., 768 F. Supp. 3d 787 (S.D. Tex. 2025). Copies of the major filings in the case may be found here.

[13] See Complaint, Nvidia Corp., No. 9404 (F.T.C. issued Dec. 2, 2021); Press Release, Fed. Trade Comm'n, Statement Regarding Termination of Nvidia Corp.'s Attempted Acquisition of Arm Ltd. (Feb. 14, 2022). Copies of the major filings in the case may be found here.

[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* Complaint, Intercontinental Exchange, Inc., No. 9413 (F.T.C. issued Mar. 9, 2023), *settled*, Decision and Order, Intercontinental Exchange, Inc., No. 9413 (F.T.C. Nov. 3, 2023). The case involved considerable federal court and administrative litigation before settling. Copies of the major filings in the case may be found here.

competition. Access to competitively sensitive information and the risk that dependence will discourage entry or investment can also matter. Guideline 6 addresses the entrenchment or extension of a dominant position, including conduct that protects a dominant firm from competitive threats. These are agency enforcement frameworks, not independent legal presumptions binding on courts. Carefully review Guidelines 5 and 6 (pp. 59-71).

Ford/Autolite. This Supreme Court decision provides the classical structuralist treatment of vertical mergers. Ford's acquisition of Autolite eliminated Ford as a potential competitor in the aftermarket for spark plugs and was found to foreclose a meaningful portion of the market by converting an independent supplier into a captive source. The Court viewed the merger through Section 7's incipiency lens, emphasizing the loss of potential competition and the danger of foreclosure without requiring detailed proof of postmerger conduct or pricing effects. The district court ordered a sweeping divestiture and imposed a ten-year ban on Ford manufacturing spark plugs, illustrating how aggressively courts of that era used structural and conduct remedies to preserve market access for rivals (slides 29-34).

The comparison with modern analysis concerns both the competitive mechanism and the evidence needed to establish it. Actual potential competition examines whether Ford would likely have entered independently, on what timetable, and with what competitive effect. Perceived potential competition examines whether incumbents already moderated their conduct because they feared Ford's entry. A modern foreclosure analysis examines whether internalizing Ford's purchases would materially disadvantage rivals, whether that strategy would be profitable, and whether competition would suffer. The Court's concern that captive supply reduced the prospects for future deconcentration supplies the historical contrast: a reduction in independent suppliers' available sales does not, by itself, explain the resulting harm to competition.

Anticompetitive information conduits. A vertical merger can harm competition without denying a rival access to an input or customer. A distributor may receive confidential prices, marketing plans, or other information from the manufacturers it serves. If one of those manufacturers acquires the distributor, it may obtain information about its horizontal rivals that it previously could not observe. The information may help it target a rival's competitive initiatives or facilitate coordination. The relevant change is the use of information acquired through the vertical relationship, even where ordinary supply and distribution continue.

Coca-Cola/Coca-Cola Enterprises illustrates this concern. Coca-Cola acquired its bottler's North American operations, which also distributed Dr Pepper Snapple products (slides 35-36). The FTC alleged that the resulting access to Dr Pepper Snapple's confidential commercial information could weaken competition and facilitate coordination (slide 37). The consent order required a firewall separating personnel who needed the information for bottling and distribution from personnel responsible for competing concentrate operations, together with monitoring provisions (slide 38). These were allegations resolved by consent, not findings after trial. The arrangement illustrates why information access, internal organization, and compliance mechanisms can matter even when there is no outright foreclosure. Read the transaction announcement (pp. 326-31), the FTC press release and complaint (pp. 332-39), and the FTC analysis of the consent order (pp. 340-42).

Looking ahead. Class 22 begins with *Comcast/NBCUniversal* as the comparator for *AT&T/Time Warner* and then turns to the AT&T transaction, the governing law, and the government's factual

evidence. Classes 23 and 24 complete the expert evidence, the remaining theories, and the implications of the decision before we turn to *GE/Avio*, the remedies note, and the Tempur Sealy reply.

Please email me if you have any questions. See you in class![16]

[16] If time permits, skim the materials on the 2020 DOJ/FTC Vertical Merger Guidelines (pp. 6-57) for additional context. These materials trace an interesting regulatory history: The 2020 Vertical Merger Guidelines were issued jointly by the 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 from the guidelines. The FTC's withdrawal created an unusual situation in which 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 the DOJ and FTC issued new joint Merger Guidelines addressing vertical mergers.