

The Draft Vertical Merger Guidelines: A Modern Approach, But Gaps and Questions Remain

BY JAMES KEYTE

THE LONG AWAITED—AND anxiously anticipated—Draft Vertical Merger Guidelines (VMG) were released by the U.S. Federal Trade Commission and U.S. Department of Justice on January 10, 2020, and they indeed appear to reflect what the Agencies are doing in practice when assessing proposed vertical mergers.¹ But whether they offer the requisite thoroughness and clarity to provide reliable guidance to the legal and business community is another matter (although, as of this writing, public comments were not yet due). It is also interesting that two of the FTC Commissioners abstained from endorsing the VMG, apparently not viewing them as aggressive or clear enough.

Set forth below is a brief description (and some observations) addressing what is in the VMG and what is not. At a minimum, we now have a much better understanding of what the Agencies have been doing when assessing proposed vertical mergers, even if the judicial arena may impose additional or different standards in an actual Clayton Act Section 7 litigation.

What Is in the Draft VMG

■ *Abandoning Traditional Vertical Merger Analyses in Favor of Assessing Rivals' Access to "Related Products"*

Perhaps the newest revelation in the VMG is that the Agencies are not necessarily looking for market structures in which the merging parties have traditional market power in two vertically related markets. Instead, in Section 2, the new focus (though clearly being used for years) centers on identifying one or more “related products” (“a product or service in the relevant market . . . to which access by the merged firm’s rivals affects competition”)—and then determining whether the merger will affect that access in a way that harms rivals and potentially (or presumably) consumers. A related product can be in the form of “inputs,” “means of distribu-

tion” or “access to a set of customers,” or presumably any other asset or resource a rival may “need” or desire in order to compete effectively.

■ *The Analysis of Market Structure Takes a Back Seat to a 20% Safe Harbor (of Sorts)*

The VMG begin, with the title “Market Participants, Market Shares and Market Concentration,” (Section 3), seemingly preparing the reader for a discussion of multi-level market power and its asserted ills and risks. Not so. Consistent with the new focus on rival access to “related products,” the VMG make clear that the Agencies consider these traditional concepts and measures to be much less relevant to the analysis than in the past. Specifically, while the VMG recount that the Agencies “normally” identify one or more relevant markets, the purpose appears to be only for assessing the “competitive significance of related products”—e.g., as stated in Section 3, “[T]he share of output in a relevant market that uses related products,” which in turn informs to the extent of potential foreclosure in a more traditional relevant market.

Relatedly, the quasi-20 percent safe harbor in the VMG requires an assessment of both the merged firm’s percentage of the relevant market that may be harmed and the percentage of the “related product” controlled by one of the merging parties. (Interestingly, there is no requisite assessment of the structure of the market for the related product itself.) As the VMG explain in Section 3, the Agencies are unlikely to challenge a vertical merger where the parties to the merger have a share in the relevant market of less than 20 percent, *and the related product is used in less than 20 percent of the relevant market*. Moreover, even with this assessment, the safe harbor may not apply for new or rapidly growing products or market shares.

■ *A Commitment to Raising Rivals' Costs (RRC) Theories and Modeling*

The most predictable and practical conformation in the VMG is the explanation that RRC is the primary unilateral effects theory of both Agencies in vertical merger analysis.² (Section 5.) In essence, the theory and related economic literature did not exist for the 1984 Non-Horizontal Merger Guidelines,³ and in that sense it is an important acknowledgment that this is what the Agencies are now

James Keyte is the Director of the Fordham Competition Law Institute, an adjunct professor of Comparative Antitrust Law at Fordham Law School, and an Associate Editor of *ANTITRUST* magazine. He is also the Director of Global Development at The Brattle Group.

using, as the DOJ did in *AT&T/Time Warner*.⁴ As explained in the VMG, a vertical merger may “diminish competition by allowing the merged firm to profitably weaken or remove the competition constraint from one or more of its actual or potential rivals in the relevant market, *by changing the terms of those rivals’ access to one or more related products.*” This, the VMG explain, can be in the form of higher prices (or lower quality) for “related products” or a complete refusal to supply.

The VMG also make clear that the Agencies are dedicated to the use of modeling RRC (including netting out the elimination of double marginalization), although the VMG note that the Agencies would not treat modeling results as “conclusive.” The VMG then highlight a few of the RRC theories typically considered, including (1) causing rivals to lose sales and, in turn, deterring innovation, entry or expansion, affecting access to finance or charging higher prices; (2) causing incremental “diversion” to the merger firm, post-merger; and (3) creating a cushion, through that diversion, to make foreclosure or RRC profitable, post-merger. (Section 5.) The Agencies would consider these theories as long as the resulting effects are not “de minimis” (which is not defined).

■ **Fencing in the “Elimination of Double Marginalization” (EDM) Credit from AT&T/Time Warner**

The DOJ’s economic expert in *AT&T/Time Warner* essentially gave the parties an upfront efficiencies credit—and quantified it for them—based on the standard economic proposition that a vertical merger typically (if not invariably) eliminates the cost of having to pay, pre-merger, the margin markup of the other firm.

The VMG not only reject any presumption (theoretical or otherwise) that the elimination of double marginalization is an efficiency in a vertical deal, in Section 6 they place the burden on the parties to “identify and demonstrate how the merger eliminates double marginalization.” Further, the VMG explain the various conditions under which the Agencies will not accept an EDM assertion, including the presence of incompatible technologies, already aligned incentives (through pre-existing contracts), and incentives to increase prices, for example, based on potential increased demand for upstream inputs. In short, the VMG put the parties on notice that EDM will no longer be a credit at the outset of a case and must be fought for like an affirmative defense.

What Is Not in the Draft VMG

Perhaps because it is an opening draft for comment, the VMG are equally notable for what is not detailed or addressed as for what is. Specifically, while the VMG explain what the Agencies are doing in some detail for an RRC unilateral effects analysis, they do little to provide an overall analytical framework, a thorough discussion of burdens of proof or, importantly, to describe the marketplace conditions under which they would have no concern, independent of the 20 percent quasi-safe harbor. Nor do they address the important issue of remedies.

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■ **What Happened to the Role of Market Structure and Competitive Dynamics?**

Unlike the 1984 Guidelines, the VMG say little, if anything, about market structure (or marketplace dynamics) and its analytical role in assessing vertical mergers. This is troubling in two respects.

First, the VMG do not expressly (or implicitly) recognize that a vertical merger does not inherently alter the market structure to “eliminate” a competitor as occurs with a horizontal merger. This was critical in *AT&T/Time Warner*, as the court highlighted that there is no “structural presumption” of potential anticompetitive effects in a vertical deal and, as a result, the government must start from scratch in attempting to prove a substantial lessening of competition in a relevant market.⁵

Second, the VMG reference market definition, but then relegate its role. Unlike the 1984 Guidelines—and what little case law exists⁶—the VMG do not require defining markets and assessing market power for *both* the upstream and downstream markets. Instead, it appears that market definition is only needed to provide context for assessing RRC or foreclosure of access to a “related product” and the 20 percent quasi-safe harbor. And, as noted, there is no analysis of market structure for the related product itself—e.g., whether there are ready demand substitutes for the related product and whether entry or repositioning is easy for that product.

This leaves the VMG with an arguably untethered RRC theory and model, as long as a party has a 20 percent share in the alleged market being harmed and in which the merged firm also controls 20 percent of the related product. And that sounds a lot like the exact theory offered and rejected by the court in *AT&T/Time Warner* (albeit primarily based on the deficiency of the model, although the decision also reflects a great concern about the DOJ’s static market analysis).⁷

One could fairly point out, then, that the VMG do not conform easily to the current state of the law, including the teachings of *Fruehauf Corp. v. FTC*,⁸ which, even back then, had a detailed discussion of what part of the market remains accessible to rivals, under what conditions, and how that relates to overall effects.

■ **Connecting RRC to Enduring, Incremental Market Power**

One of the more troubling aspects of the VMG is that they never explain how the Agencies connect a theory of RRC

with a “substantial lessening of competition” in a relevant market. Moreover, we know that Clayton Act Section 7 contemplates an incremental and enduring market-wide effect for there to be a real risk to competition and consumers.⁹ Absent that, the Agencies would effectively be protecting rivals from mere changes in vertical bargaining positions—hardly what Section 7 envisioned and clearly a problematic theory of enforcement after *AT&T/Time Warner*.

Even the EU’s 2004 non-horizontal merger guidelines require as much.¹⁰ For example, in addition to a careful assessment of the extent of foreclosure and incentives and ability to carry out an RRC or foreclosure strategy, the EU guidelines detail when and why there is not likely to be an “overall likely impact on effective competition,” including the assessment of the ability of rivals to switch to other resources, the presence of buyer power, or repositioning and entry. U.S. antitrust law, however, is even more demanding in requiring evidence of market-wide harm than the EU.

■ *When Does Modeling Not Work?*

Given the prominence that modeling plays in the VMG we might have expected some guidance on what the Agencies view as reliable modeling and what they view as not reliable. This was a key aspect of the *AT&T/Time Warner* litigation, where the court spent pages explaining what it saw as right or wrong in the econometric modeling undertaken by the government. It would be useful, then, for the VMG to highlight for practitioners the Agencies’ position on what makes for a relevant and robust model, whether for RRC or more sophisticated structural models that assess the interaction among all demand and supply agents in the actual and “but-for” worlds. As it is, parties are left to imagine or discern what and how the Agencies may be modeling in any particular vertical merger, leaving any difference or disagreements for litigation. This is not a recipe for predictability.

■ *The Subject of Remedies Cannot Be Ignored*

Finally, one could suppose that remedies should not be the subject of “guidance” or that the principles in the DOJ’s existing Remedies Guidelines¹¹ should suffice. Yet, as a practical matter, companies in years past have routinely made an array of deals (private and with Agency consent) that resolved Agency concern in vertical mergers.¹² Moreover, in light of *AT&T/Time Warner*, one would think that the Agencies might address the practice of a party-driven “fix-it-first” or, more problematically, “fix-it-during” litigation proposals, if not simply to provide constructive notice to the parties (and courts) well in advance of any future litigation.

Stay Tuned

In sum, there is a real question here of completeness, whether the Agencies intended a minimalist approach as the framework itself or, instead, offered a mere opening salvo. But, in recent years, there has been an enormous amount written on what these guidelines should (or should not) contain and so much more certainly could have been addressed. For his part, for example, Professor Steven Salop is likely to see a need both to expand the types of competitive risks involved (including through use of vertical GUPPI analysis) as well as in assessing the potential procompetitive benefits.¹³

In the meantime, it will be interesting to watch the comments flow in and see what translates into concrete changes. Even then, there inevitably will be new Section 7 vertical merger litigations that lead to a more complete and predictable framework and set of principles for assessing vertical mergers. In the end, of course, courts are the ultimate authors of “guidelines,” but that may still take some time to unfold. ■

¹ U.S. Department of Justice and the Federal Trade Commission Vertical Merger Guidelines, Released for Public Comment on Jan. 10, 2020.

² While the VMG address potential coordinated effects, there is not much new there; instead, the VMG primary focus is on unilateral effects.

³ See U.S. Dep’t of Justice, Non-Horizontal Merger Guidelines (1984), <https://www.justice.gov/public/guidelines/2614.pdf>.

⁴ *United States v. AT&T, Inc.*, 916 F.3d 129 (D.C. Cir 2019).

⁵ See *id.* at 1032.

⁶ In addition to *AT&T/Time Warner*, see, e.g., *Fruehauf Corp. v. FTC*, 603 F.2d 345 (2d Cir. 1979).

⁷ See James A. Keyte, *The AT&T/Time Warner Decision: More Than Meets the Eye*, ANTITRUST, Summer 2019, at 20.

⁸ *Fruehauf*, 603 F.2d at 353.

⁹ See generally *United States v. Gen. Dynamics Corp.*, 415 U.S. 486, 498 (1974); *Brown Shoe Co. v. United States*, 370 U.S. 294, 324 (1962).

¹⁰ See Guidelines on the Assessment of Non-Horizontal Mergers Under the Counsel Regulation on the Control of Concentrations Between Undertakings, Counsel Regulation (EC) No. 139/2004 of Jan. 2004, 2004 O.J. (L 240) 1.

¹¹ See U.S. DEP’T OF JUSTICE, ANTITRUST DIV., POLICY GUIDE TO MERGER REMEDIES (2011), <https://www.justice.gov/sites/default/files/atr/legacy/2011/06/17/272350.pdf>.

¹² See James A. Keyte & Kenneth B. Schwartz, *Getting Vertical Mergers Through the Agencies: “Let’s Make a Deal,”* ANTITRUST, Summer 2015, at 10.

¹³ See generally Steven C. Salop & Daniel P. Culley, *Revising the US Vertical Merger Guidelines: Policy Issues and an Interim Guide for Practitioners*, J. ANTITRUST ENFORCEMENT, Vol. 4, Issue 1, Apr. 2016, at 1.