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INSIGHT: Proposed Vertical Merger Guidelines—Increased Transparency or Opaque Glass?

By Joel Mitnick and Ngoc Pham Hulbig
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New proposed vertical merger guidelines from the FTC and DOJ essentially codify the informal lore in the antitrust bar that vertical mergers generally pose less of a potential anticompetitive threat than certain horizontal mergers, Cadwalader attorneys write. They say the guidelines reserve wide latitude for the government to justify almost any outcome of a vertical merger investigation.

The Federal Trade Commission and Department of Justice proposed vertical merger guidelines, which the agencies will enforce jointly, may give the appearance of analytical clarity, but actually reserve wide latitude for the government to justify almost any outcome of a vertical merger investigation.

The FTC's vote to issue the proposed guidelines proceeded along party lines, with the three Republican commissioners voting to issue them and the two Democratic commissioners abstaining. The public comment period ends Feb. 10. The DOJ simultaneously revoked its 1984 vertical guidelines, which had been largely ignored by enforcers and the courts for more than a decade.

The antitrust bar has lauded the agencies for proposing new guidelines. The bar generally favors clarity and transparency in law enforcement. Clarity and transparency lead to keener advice; keener advice leads to greater client certainty; and greater client certainty arguably leads to better business decisions (assuming that the light is sunshine and not haze).

Overall Approach

Antitrust enforcement analytically divides the world of mergers into horizontal mergers, those between competitors, and vertical mergers, those between two connected firms in a vertical supply chain. The agencies already have in force a set of joint horizontal merger guidelines.

As a general matter, the proposed vertical guidelines would essentially codify the informal lore in the antitrust bar (including economists who are the satellites of that bar) that vertical mergers generally pose less of a potential anticompetitive threat than certain horizontal mergers.

The guidelines expressly identify, and incorporate into an analytical framework, the three types of harm most commonly associated with vertical mergers. But, as a starting point, the guidelines reference certain principles (*e.g.*, relevant product and geographic markets) that are already familiar as analytical tools in the horizontal guidelines.

'Sort of' Safe Harbor

The guidelines open at a seemingly strange place and with an odd quasi-exemption. Picking up on the market definition and market concentration provisions in the horizontal guidelines, the proposed vertical guidelines explain that the agencies will begin their analyses of a vertical merger by examining the relevant upstream (supplier) and downstream (customer) markets in which two firms seek to be combined through merger. Focusing on one market at a time (the relevant market), the other (upstream or downstream) market is referred to as the "related market."

The guidelines then provide that: "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%, and the related product is used in less than 20% of the relevant market."

The provision was wildly controversial among the commissioners themselves, with one of the Republican commissioners (Christine S. Wilson) writing separately that the business community is entitled to the greater clarity that comes with a definitive safe harbor and the two Democratic commissioners (Rohit Chopra and Rebecca Kelly Slaughter) decrying that the presumption of non-enforcement may lead to excessive approvals of dangerous mergers.

Moreover, the agencies did not even try to justify the 20% number with empirical support, and a 20% market combination certainly is not presumed lawful under the horizontal merger guidelines. Nevertheless, the presumption of lawfulness accords with the general sense that vertical mergers should be given more enforcement leeway than horizontal mergers.

We would encourage the agencies to explain why 20% is the right number, and either follow Commissioner Wilson's suggestion for a definitive safe harbor or else provide greater clarity about the nature and strength of this presumption against enforcement.

Harm to Competition

Although academics may invent many theories of potential vertical merger harm, the guidelines focus on three types of harm that are most associated with vertical mergers: (1) foreclosure; (2) raising rivals' costs; and (3) access to confidential information.

Foreclosure can occur where a supplier refuses to sell to competitors of its newly acquired downstream business (or a downstream seller refuses to buy from a rival of its newly acquired upstream supplier). Raising rivals' costs is a less draconian strategy than foreclosure where the supplier raises prices to competitors of its downstream affiliate.

Less often of concern (but the subject of a recent FTC enforcement action), a combined vertical firm may gain access to competitively sensitive information of an upstream or downstream rival that is a buyer or supplier of the combined entity such that the competitor's information may affect the combined firms' competitive behavior in that overlapping upstream or downstream market.

Although the guidelines provide examples of foreclosure and raising rivals' costs that are consistent with well-understood fact scenarios, the guidelines also state that the agencies may "consider any reasonably available and reliable evidence to address the central question of whether a vertical merger may substantially lessen competition."

This catch-all provision may potentially swamp the more narrow provisions addressing unilateral and coordinated effects. Accordingly, the agencies may wish to clarify whether there are any limits to the theories that staff may be allowed to pursue in opposing a vertical merger.

Elimination of Double Marginalization

Elimination of double marginalization (EDM) is the reason most vertical mergers are presumed to be procompetitive. EDM is most easily explained as cutting out (or at least lessening) the cost of the middle-man. So powerful is this dogma that the guidelines enshrine it in its own section, separate and apart from other more amorphous efficiencies. (Again controversy, as the Democratic commissioners would deny EDM's presumed existence.)

But in a twist that is surely to provoke public comment, the agencies back off of creating a presumption in favor of EDM and instead place a quasi-burden on the merging parties to "demonstrate whether and how the merger eliminates double marginalization."

By placing that burden on the parties rather than the reverse on staff, the agencies arguably will foment a significant level of uncertainty on the part of vertical businesses that wish to combine. We would urge the agencies to consider establishing a presumption of EDM so that the government bears the burden of demonstrating that a particular vertical merger is anticompetitive rather than a presumption that every proposed vertical deal must overcome.

Remedies

Finally, a word about remedies—there is not a single word about remedies in the guidelines. That is unfortunate because both agencies have proclaimed over the past several years that they now disfavor conduct remedies in vertical cases, a stark departure from past practice.

Moreover, the refusal to discuss remedies, combined with some of the catch-all provisions and quasi-burdens, leads to a set of guidelines that may provide a more apparent analytic framework than actually exists.

For example, the DOJ would presumably rely on these guidelines the next time it faces a proposed combination of a firm like AT&T with a firm like Time Warner in a market in which they existed. If the guidelines are flexible enough to justify a future challenge to such a transaction, then what have we learned since that transaction and how is that learning reflected in the guidelines? Perhaps the government can address that question following the public comment period.

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Author Information

Joel Mitnick is a partner in Cadwalader's Antitrust and Global Litigation Groups based in its New York office. A former trial lawyer at the FTC, he focuses on antitrust matters on behalf of a wide array of financial market, life science, media, service industry and industrial clients, representing them in federal and state antitrust investigations, antitrust class actions and merger clearance proceedings.

Ngoc Pham Hulbig is a counsel in Cadwalader's Charlotte office whose practice focuses on U.S. and global pre-merger notification requirements. She also counsels clients in the full range of antitrust matters, including mergers and acquisitions, joint ventures, and in connection with investigations by the DOJ and the FTC.