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FTC, DOJ Release Updated Vertical Merger Guidelines

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On January 10, 2020, the Federal Trade Commission and Department of Justice's Antitrust Division ("the Agencies") announced proposed draft Vertical Merger Guidelines ("VMGs") for public comment. Vertical mergers combine two or more companies that operate at different levels in the same supply chain. The VMGs describe how the Agencies currently analyze vertical mergers and provide updated insight on vertical merger enforcement policy.

Existing Agency guidance on vertical mergers, promulgated in 1984, has been sharply criticized as outdated and not reflective of the Agencies' current enforcement approach. If accepted, the VMGs will replace the 1984 guidance, which will be withdrawn.

This *Alert* summarizes the VMGs and provides practical takeaways for firms considering transactions with a vertical component. In short, the VMGs largely memorialize the Agencies' existing approach to vertical merger enforcement and contain no surprises. However, given the Agencies' ongoing attention to the subject, firms considering transactions involving companies with vertical relationships should continue to assess potential antitrust issues thoroughly before signing. In addition, because the draft VMGs emphasize an empirical approach to vertical merger analysis, in many cases it will be advisable to retain an expert economist. Lastly, the outcome of the 2020 Presidential election likely will provide meaningful clarity on the Agencies' going-forward approach to vertical mergers.

No Significant Departures from Existing Agency Practices

Critically, the draft VMGs do not depart from the Agencies' current analytical approach to vertical mergers. Rather, they reflect the status quo, as seen in recent vertical enforcement actions such as CVS/Aetna, Cigna/Express-Scripts, AT&T-DirecTV/Time Warner, United Health Group/DaVita Medical Group, and Staples/Essendant.

In those matters, the Agencies focused primarily on one of three issues, each reflected in the draft VMGs.

- **Foreclosure and Raising Rivals' Costs.** To what extent will the merged firm have the incentive to prevent downstream competitors from obtaining key inputs, including by raising the cost of obtaining such inputs for downstream competitors?
- **Access to Competitively Sensitive Information.** Will the merger provide the merged firm with access to sensitive business information about upstream or downstream rivals that was not available before the merger, and to what extent will the merged firm be able to use that information to the detriment of competition?
- **Facilitation of Collusion.** To what extent will the merger facilitate the ability of either the upstream or downstream entity to coordinate on post-merger price or output?

With respect to foreclosure and raising rivals' cost, a vertical merger may encourage the merged firm to refuse to supply competitors of the downstream business with important upstream inputs or to increase the costs of those inputs. The Agencies may then investigate whether the combination creates or enhances such strategic incentives. As described in the VMGs, and consistent with Agency practice, this analysis is highly fact-specific and empirical in nature and focuses on the competitiveness of both the upstream and downstream markets and, ultimately, likelihood of success and potential impact of post-merger strategic behavior, both in terms of profitability and magnitude of harm.

Clarifications to Agency Enforcement Policy

In addition, the VMGs clarify three key points with respect to Agency policy and practice.

First, the VMGs explain that the Agencies "are unlikely to challenge a vertical merger" where the parties' combined market shares in *each of* the upstream and downstream markets are less than 20%. Although these thresholds are lower than expected (and lower than comparable case law), it is likely that the Agencies will continue to clear deals where the upstream and downstream shares exceed the thresholds.

Second, the VMGs acknowledge vertical mergers often result in dynamic merger-specific efficiencies, including the elimination of double marginalization, which can create incentives for the merged firm to reduce prices and expand output downstream. At the same time, the VMGs unsurprisingly place the burden on the merging parties to identify and quantify any deal-related efficiencies. This is also reflective of current Agency practice in both horizontal and vertical transactions: the Agencies fairly credit verifiable, merger-specific efficiencies, but only when consistent with the parties' economic incentives as shown through empirical or other dispositive evidence.

Third, the 1984 Guidelines describe in detail the competitive harms caused by mergers involving the acquisition of or by one party that is a potential entrant into the other party's market. The VMGs, in contrast, do not once mention "elimination of potential competition" as a theory of harm. Presumably, the Agencies will take the position that it is a horizontal theory of harm, covered by the *Horizontal Merger Guidelines* rather than the VMGs, but they have not made that clear to date. Nonetheless, if the VMGs become effective, the theory will not be specifically addressed in any official Agency guidelines. Its absence is noteworthy given recent Agency commentary (and public attention) regarding mergers between nascent competitors, particularly in technology markets.

Considerations for Firms Pursuing Vertical Deals

Going forward, the Agencies will continue to scrutinize vertical mergers less than horizontal mergers. Vertical mergers do not reduce the number of competitors in a market and often are motivated by significant and legitimate procompetitive efficiencies. Thus, for the last 30-plus years, vertical mergers have been less of an enforcement priority compared to horizontal mergers. The announcement of the VMGs will not change that.

However, the Agencies are paying more attention to vertical deals today, in large part because there are more of them occurring in concentrated or moderately concentrated industries. Given the VMGs place heightened emphasis on empirical evidence, the Agencies are likely to conduct economic analysis to assess the possibility of foreclosure or raising rivals' cost. Merging parties therefore should carefully consider budgeting for, if not retaining, an expert antitrust economist.

Even if economic work ultimately is not submitted to the Agencies, such work can be invaluable in terms of preparing for affirmative advocacy and responding to potential Agency questions. In many cases, the perspective of an economist can help clarify complex vertical issues in a way that expedites clearance or avoids a Second Request.

Whether to undertake economic work (and how much work to do) depends on the same facts that inform an antitrust risk assessment that is typically performed pre-signing: the extent of concentration in the upstream and downstream market, parties' relative positions in those markets, the ability of other firms to enter or expand in those markets, and other industry dynamics. Antitrust counsel can — and should — help inform the decision, balancing cost with being prepared in light of the facts.

Looking Ahead to 2020

The draft VMGs did not receive unanimous support from the FTC and DOJ. In fact, two of the five FTC Commissioners (both Democratic appointees in a Republican-controlled Commission), abstained from voting to release the VMGs. These Commissioners cited general concerns about the enforcement challenge of vertical mergers and specific concerns about the failure of the VMGs to address those challenges comprehensively and head-on.

The abstentions underscore a key antitrust enforcement dynamic to monitor in this critical election year. There is strong consensus that the VMGs must be updated, and that the draft VMGs soundly reflect current vertical merger policy (save, perhaps, the 20% threshold). But, there remain fervent differences of opinion as to what vertical merger enforcement *should* look like moving forward, and those differences break along political lines. If a Republican candidate wins the 2020 Presidential election, vertical merger enforcement would likely continue to reflect the approach of the VMGs over the next four years. If, however, a Democratic candidate wins the election (and depending on which Democratic candidate), more expansive theories of vertical harm may gain momentum, leading to more expansive, potentially turbulent, vertical merger investigations.

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