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U.S. Antitrust Regulators Publish Significant Guidance Concerning Vertical Mergers – 30-Day Public Comment Period

For the first time in 36 years, U.S. antitrust regulators have published guidance concerning their analysis of vertical mergers (*i.e.*, mergers between companies involved in different levels of the same supply chain). The guidelines, which have been issued in draft form for public comment until February 11, 2020, provide significant insights into the analyses that would be applied by U.S. regulators and will be significant for companies planning vertical combinations in many industries. The guidelines could substantially change (i) the way in which vertical mergers are assessed in allocating antitrust risk in the context of merger negotiations; (ii) the number of vertical mergers subjected to lengthy investigations by the regulators; and (iii) the number of vertical mergers that lead to enforcement actions.

The draft guidelines decline to adopt a standard under which regulators would view vertical mergers as presumptively lawful or unlawful, but propose, among other things, a 20% "screen" that would serve as a preliminary indicator of whether a vertical merger warrants scrutiny (*i.e.*, if the merged firm has a less than 20% share in a relevant market and a less than 20% share in a market vertically "related" to the relevant market, the regulators are unlikely to view the merger as problematic). Although the "screen" is informative, the guidelines emphasize that enforcement decisions will continue to be subject to a fact-specific competitive effects analysis in each case.

SUMMARY

Although updated Horizontal Merger Guidelines (which apply to mergers between competing companies) were issued in 2010, guidelines specific to vertical mergers have not been updated since the 1984 Non-Horizontal Merger Guidelines, which have long been viewed as outdated. As vertical mergers have seen increased scrutiny over the last few years—including the DOJ's widely publicized challenge to the AT&T/Time Warner transaction—industrial companies and investors actively sought greater transparency into how the Federal Trade Commission ("**FTC**") and the Antitrust Division of the U.S. Department of Justice ("**DOJ**") analyze and make enforcement decisions concerning vertical mergers. On January 10, 2020, the FTC and DOJ released for public comment Draft Vertical Merger Guidelines ("**Draft Guidelines**"). Although the Draft Guidelines reflect collaboration between the two agencies, the FTC's two Democratic Party Commissioners abstained from voting for release of the Draft Guidelines, and issued separate statements criticizing the Draft Guidelines as too permissive of industrial merger activity. The Draft Guidelines are subject to a 30-day public comment period, giving interested parties until February 11, 2020 to submit feedback, and thus the Draft Guidelines are subject to change following public commentary.

The Draft Guidelines provide a framework that would guide the DOJ's and FTC's enforcement decisions and would be intended to "assist the courts" in applying U.S. antitrust laws. Although the Draft Guidelines describe "distinct considerations" for vertical mergers, many principles from the 2010 Horizontal Merger Guidelines are incorporated by reference (*e.g.*, how to define the relevant market in assessing a transaction's competitive effects, entry analysis, and treatment of failing firms).

Under the Draft Guidelines, the initial analysis is two-pronged: (i) definition of the relevant market, and (ii) definition of a "related market," which is a "product or service that is supplied by the merged firm, is vertically related to the products and services in the relevant market, and to which access by the merged firm's rivals affects competition in the relevant market" (*e.g.*, "an input, a means of distribution, or access to a set of customers"). After defining those elements, the Draft Guidelines apply a preliminary "screen" to identify mergers that likely do not raise competition concerns versus those that appear to warrant closer scrutiny. The agencies are "unlikely to challenge" a vertical merger if the merging parties have a combined share of less than 20% in the relevant market *and* the related product is used in less than 20% of the relevant market. The 20% "screen" is not "rigid" or conclusive, giving the agencies broad discretion to scrutinize transactions that fall below this threshold if they have reason to suspect potential competitive harm. The Draft Guidelines do not go so far as to declare circumstances—whether based on concentration or other market factors—under which the agencies will presume a vertical merger is lawful or unlawful, and the "screen" is only a starting point.

Progressing past the "screen," the Draft Guidelines state that the agencies' enforcement analysis will turn largely on the likely competitive effects of a given transaction. In analyzing the competitive effects of vertical

combinations, the agencies will consider substantially the same kinds of "reliable evidence" identified in the Horizontal Merger Guidelines (*e.g.*, the documents and statements of the merging parties). The Draft Guidelines identify three additional factors, unique to vertical mergers, that should be considered: (i) "pre-existing contractual relationships," which may affect characteristics of the relevant market; (ii) evidence of "head to head" competition between one merging firm and a rival of that merging firm that does business with the other merging firm; and (iii) whether the "related product" is new and its share of use is growing "rapidly" in the relevant market (in which case the "screen" may inaccurately identify a vertical merger as benign).

The Draft Guidelines also identify two non-exhaustive theories of unilateral competitive effects that the agencies will consider in evaluating a vertical merger: (i) foreclosure and raising rivals' costs, and (ii) reduced competition resulting from access to competitively sensitive information.

Regarding foreclosure and raising rivals' costs, the agencies would consider whether the merged firm would have the incentive and ability to substantially lessen competition by "changing the terms" of rivals' access to a related product. The Draft Guidelines set forth a test that analyzes whether foreclosure or raising rivals' costs would (i) decrease rivals' sales or competitiveness; (ii) increase the merged firm's sales; and (iii) increase profit for the merged firm. This test also considers a fourth factor, whether the "magnitude" of the likely foreclosure or increase in rivals' costs is "not *de minimis*." If all four factors are met, the merger will "potentially raise significant competitive concerns and often warrant scrutiny."

Regarding access to competitively sensitive information, the Draft Guidelines identify two theories of harm to competition: (i) the merged firm, as a supplier of a related product to rivals, may have access to information about those rivals' "procompetitive business actions," which would allow the merged firm to act anticipatorily and could chill rivals from taking such actions, and (ii) because of reluctance to share competitively sensitive information, rivals will forego the benefits of purchasing related products from the merged firm. The Draft Guidelines do not provide more bright line guidance regarding this theory, which will make it challenging for parties and their counsel to assess antitrust risk and navigate the merger clearance process until there is substantial experience with the regulators' approach to this theory.

In the context of competitive effects, the Draft Guidelines address elimination of double marginalization ("**EDM**") (*i.e.*, combining upstream and downstream profit margins within a single firm, which can create the incentive to reduce prices to end users) and acknowledge the potential of EDM to mitigate or neutralize entirely the anticompetitive effects of vertical mergers. However, the Draft Guidelines state that: (i) the agencies generally will require the merging parties to demonstrate EDM; (ii) the theory will not be credited if the downstream party merging firm cannot use inputs from the upstream merging firm; (iii) the theory will receive less credit if the merging firms "already engaged in contracting that aligned their incentives" before the merger; and (iv) in certain situations, notwithstanding EDM, the merged firm could have incentive to raise end-user prices (*e.g.*, if raising end-user downstream price will cause a shift in downstream sales in the relevant market to a rival, which in turn will need to purchase more profitable inputs from the merged firm). Subject to these caveats, the Draft Guidelines state that the agencies "will not challenge a merger if the net effect of elimination of double marginalization," including outside of the particular relevant market, "means that the merger is unlikely to be anticompetitive in any relevant market." The Draft Guidelines' discussion of EDM suggests it will play a meaningful role in the agencies' calculus, making it a worthwhile point of emphasis for companies seeking clearance of vertical mergers.

The Draft Guidelines include an important note to the effect that a vertical merger could lead to coordinated effects if the merged firm obtains the ability to "eliminate or hobble" a "maverick" competitor (*i.e.*, because the maverick needs an input supplied by the merged firm). The Draft Guidelines suggest that in this situation, the ability to harm a maverick competitor increases risk of coordination among more established rivals. Finally, while the Draft Guidelines acknowledge the potential for vertical mergers to generate efficiencies, they do not alter the analytical framework enshrined in the Horizontal Merger Guidelines, which places the burden on merging parties to substantiate any claimed efficiencies.

IMPLICATIONS & RESPONSE

The Vertical Merger Guidelines could substantially change (i) the way in which vertical mergers are assessed in allocating antitrust risk in the context of merger negotiations; (ii) the number of vertical mergers subjected to lengthy investigations by the agencies; and (iii) the number of vertical mergers that give rise to enforcement actions. Although the Draft Guidelines clarify the factors likely to lead to an in-depth investigation and identify factors of mergers that likely would be challenged, the 20% "screen" could disturb the *status quo* under which many vertical mergers were considered procompetitive—or at least competitively neutral—and thus not subjected to lengthy investigations or serious risk of enforcement action.

The Draft Guidelines are open for public comment until February 11, 2020, and Sullivan & Cromwell is actively consulting with clients and other interested parties seeking to understand and address the Draft Guidelines in the context of the public comment process. One FTC Commissioner (Christine Wilson) who voted in favor of release of the Draft Guidelines also issued a statement encouraging public input, in particular, on the following topics:

- Elimination of Double Marginalization (EDM): whether the agencies' treatment of EDM should be aligned more closely with the economic literature, which recognizes the "significant benefit" of EDM and the reasons such benefits may not be achieved by contract;
- Symmetry: whether the agencies should assess procompetitive merger effects (*e.g.*, EDM) and anticompetitive merger effects (*e.g.*, raising rivals' costs) symmetrically, including the extent to which the effects are merger-specific;

- Safe Harbor: whether the Vertical Merger Guidelines should establish a definitive safe harbor when a merger involves only "relatively concentrated" markets, and, if so, what safe harbor threshold is appropriate;
- Market Definition: whether the agencies should adopt the looser requirement proposed in the Draft Guidelines to define one relevant product and identify a "related product," or continue to define two relevant product markets (*e.g.*, upstream and downstream); *and*
- *De Minimis* Effects: what magnitude of anticompetitive effects the agencies should view as "*de minimis*," particularly in light of EDM and vertical efficiencies.

Parties who may be affected by the Draft Guidelines should consider submitting comments, especially on issues identified by Commissioner Wilson or concerns described in the statements of the Democratic Commissioners who abstained from voting for release of the Draft Guidelines, as these are issues on which public comments could have a particular impact. Companies in the technology, healthcare, defense and telecommunications sectors are likely to have particular interest in shaping the final guidelines.

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