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U.S. Antitrust Regulators Publish Final Vertical Merger Guidelines

On June 30, 2020, the Antitrust Division of the U.S. Department of Justice and the Federal Trade Commission jointly issued final Vertical Merger Guidelines outlining considerations relevant to application of the antitrust laws to transactions combining assets at different levels of a supply chain. This guidance will apply to any transaction not strictly confined to combining assets at the same level of a supply chain.

SUMMARY & IMPLICATIONS

The final Vertical Merger Guidelines ("Final Guidelines") are the result of a nearly two-year collaboration between the Antitrust Division of the U.S. Department of Justice ("DOJ") and the Federal Trade Commission ("FTC"). The Final Guidelines modify the earlier draft Vertical Merger Guidelines ("Draft Guidelines"), which the agencies published in January 2020, to reflect public comments. There are three significant ways the Final Guidelines have evolved. The Final Guidelines:

I. abandon the concept of a "20% screen" to identify mergers that are unlikely to be anticompetitive, and decline to create any explicit safe harbor based on market structure;

II. clarify how the agencies will assess potential benefits related to the elimination of double marginalization ("EDM"); and

III. expand the scope of the guidance to capture not only strictly vertical mergers, but also "diagonal" mergers (which are described as combinations of firms/assets at different stages of competing supply chains) and mergers of complements.

Vertical Merger Guidelines' Broad Application to Non-Horizontal Transactions

The Final Guidelines have broad applicability to any kind of "non-horizontal" transaction. Warning against an overly narrow construction of the term "vertical," the Final Guidelines state that they should be construed to apply to a wide range of non-horizontal transactions, including strictly vertical mergers (mergers between

companies involved in different levels of the same supply chain, e.g., a supplier of oranges merges with a producer of orange juice), "diagonal mergers" (mergers combining firms or assets at different stages of competing supply chains, e.g., an electronics firm that produces a component that enhances wireless capability in low-end computers is acquired by a manufacturer of high-end computers, which cannot use the target's component but may have an incentive to reduce competition in the market for computers), and mergers of complements involving vertical issues (e.g., manufacturers of electric scooters use batteries and motors; the leading maker of motors for scooters mergers with a manufacturer of scooter batteries).

Market Definition and the Role of Market Shares and Concentration

Under the Final Guidelines, the starting points for analyzing vertical transactions are (i) defining the relevant markets and (ii) delineating the related products. A "related product" is defined as a "product or service that is supplied or controlled by the merged firm and is positioned vertically or is complementary to the products and services in the relevant market."

The Final Guidelines state that the agencies may consider market share and measures of concentration in their assessment of competitive effects. The market share and concentration thresholds set forth in the Horizontal Merger Guidelines, however, will not be treated as "screens for or indictors of competitive effects from vertical theories of harm." Importantly, as noted above, the Final Guidelines omit the Draft Guidelines' screening provision which provided that the agencies were "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.

Most Common Unilateral Theories of Harm

Consistent with the Draft Guidelines, the Final Guidelines identify (1) "foreclosure," (2) "raising rivals costs" and (3) dissemination of competitively sensitive information as the most common types of unilateral effects that may arise from non-horizontal mergers, although the agencies caution that these are not the only possible theories of harm in the context of non-horizontal mergers.

Regarding foreclosure and raising rivals' costs, the Final Guidelines discuss two important conditions: (i) ability and (ii) incentive. When assessing the ability prong, the agencies will ask whether a merged firm, by altering the terms on which it provides a "related" product to one or more rivals, would be able to cause those rivals to lose significant sales in the relevant market or otherwise compete less aggressively. If rivals to the merged firm could readily switch their purchases to alternatives to the related product, including self-supply, then this element will not be satisfied and the merger in question would "rarely warrant close scrutiny for its potential to lead to foreclosure or raising rivals' costs." When assessing the incentive prong, the agencies will ask if "the merged firm, as a result of the merger, would likely find it profitable to foreclose rivals, or offer inferior terms for the related product, because it benefits significantly in the relevant market when rivals lose sales or alter their behavior." Failure to satisfy this condition will, again, discourage scrutiny

under a foreclosure or raising rivals costs theory. On the other hand, mergers that satisfy both of these conditions will "potentially raise significant competitive concerns and often warrant scrutiny."

Concerning access to competitively sensitive information, the Final Guidelines identify two theories of harm. First, by virtue of the merger, the merged firm may gain access to a rival's competitively sensitive business information and may use that information to inform its competitive response to a rival's competitive activity. This may, in turn, have a chilling effect on the rival's competitive activity. Second, because of reluctance to share competitively sensitive information, rivals may forego the benefits of purchasing related products from the merged firm altogether and, in turn, become less effective competitors. Unfortunately, the Final Guidelines do not provide guidance concerning what types of competitively sensitive information will raise particular concerns, nor do they explain whether concerns related to the transfer of competitively sensitive information would ever form the basis for the agencies challenging a merger, or simply lead to a firewall remedy.

Notably, the Final Guidelines also address the potential for vertical mergers to diminish competition through the facilitation of coordination. Specifically, the Final Guidelines provide that coordinated effects may arise when a vertical merger (i) eliminates a maverick or (ii) causes changes to market structure or access to confidential information that allows competitors to form a tacit agreement, better detect cheating on a tacit agreement, or better punish cheating.

Efficiencies and Procompetitive Effects

The Final Guidelines emphasize that vertical mergers have the capacity to create more efficient or innovative firms that may generate benefits for competition and consumers. In particular, they recognize that vertical mergers can result in lower prices to consumers through EDM (i.e., combining upstream and downstream profit margins within a single firm, which can create an incentive to reduce prices to end users). Because this benefit stems from the alignment of economic incentives between merging firms, the Final Guidelines state that EDM is different in kind than the categories of efficiencies generally associated with horizontal mergers (e.g., production, distribution).

In the Final Guidelines, the agencies elaborate on how they assess EDM-related efficiencies claims. In particular, the Final Guidelines specify what types of evidence will garner the most weight in this assessment. Specifically, when evaluating whether it would likely be less costly for a merged firm to self-supply a given input post-merger, evidence of existing contracting practices is highlighted as "often the best evidence" of the input prices the downstream firm would pay absent the merger. The agencies will also consider contracts between similarly situated firms in the same industry and the merging firm's contracting efforts. The Final Guidelines also suggest certain limits on the bases on which the agencies should reject EDM claims, including that the agencies will not "reject the merger specificity of the elimination of double marginalization solely because it could theoretically be achieved but for the merger, if such practices are not reflected in documentary evidence."

Finally, it is worth noting that the FTC's vote to issue the Final Guidelines was split 3-2 along party lines. FTC Chairman Joe Simons, Commissioner Christine Wilson, and Commissioner Noah Phillips—all Republicans—formed the majority, while Democratic Commissioners Rebecca Slaughter and Rohit Chopra voted against issuance of the Final Guidelines and issued dissenting statements critiquing the Final Guidelines as too permissive. In light of this vote, a change in the Commission's political balance could result in the antitrust regulators adopting a less favorable approach to non-horizontal transactions than that articulated in the Final Guidelines.

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