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BETWEEN ABSOLUTE AND AMORPHOUS: THE DRAFT GUIDANCE ON VERTICAL MERGERS: COMMENTARY ON THE DRAFT 2020 GUIDELINES

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Businesses at different levels in the supply chain of a product choose to merge ("vertical mergers," compared with "horizontal mergers" where businesses at the same level in the supply chain merge) for a variety of reasons, many of which can be beneficial to competition and/or consumers. Vertical mergers can lead to efficiencies in supply chains, eliminations of multiple profit margins, and elimination of markups. These efficiencies can be why vertical mergers are not often challenged by the Department of Justice or Federal Trade Commission (the "Agencies"). However, as our economy becomes more integrated and several companies expand outside of their original business models (Amazon's purchasing Whole Foods, for example), regulators are expressing greater concern about the anticompetitive effect of vertical mergers. In 2018, the government unsuccessfully challenged the merger between Time Warner, an entity that creates media content, and AT&T, a downstream entity that distributes it.

Under the Clayton Act, 15 U.S.C. § 12, *et. seq.,* the government and private parties may prevent mergers when "the effect of such acquisition may be to substantially lessen competition, or to tend to create a monopoly." 15 U.S.C. § 18 (emphasis added). Notably, this provision does not require actual harm to competition or create a monopoly. The Clayton Act is prophylactic, not reactive.

Although the Federal Agencies have released several guidance documents describing how they analyze mergers, most recently the 2010 Horizontal Merger Guidelines, the guidelines for vertical mergers have not been updated since the 1984 Non-Horizontal Merger Guidelines. In a desire to update outdated guidelines, and perhaps in response to fallout from recent vertical merger cases, such as the AT&T/Time Warner loss, the Agencies released their draft 2020 Vertical Merger Guidelines (the "Draft Guidelines"). The Draft Guidelines incorporate the analytical framework and methodology of the 2010 Horizontal Merger Guidelines, but address several considerations more salient to vertical mergers.

The Agencies are requesting public comments on the Draft Guidelines no later than February 11, 2020, which can be made via email to verticalmergerguidelines@ftc.gov and verticalmergerguidelines@usdoj.gov.

The "Safety Zone"

One area ripe for comment is the purported "safety zone." The Draft Guidelines advise that the Agencies would be unlikely to challenge a merger if the relevant market share of the entities was less than 20% of the market and the product is used in less than 20% of the market. While this language is reminiscent of similar safety zones the Agencies have previously adopted, it lacks the definitiveness and framework characteristic of those safety zones. For instance, in the 2000 Guidelines for Collaborations Among Competitors, the Agencies advised, "Absent extraordinary circumstances, the Agencies do not challenge a competitor collaboration when the market shares of the collaboration and its participants collectively account for no more than twenty percent of each relevant market in which competition may be affected."

The Draft Guidelines lack the firmness of the "absent extraordinary circumstances" language, and merely state that this "threshold is not to provide a rigid screen." The Agencies seemingly acknowledge this vacillation saying it only "provide[s] one way to identify some mergers unlikely to raise competitive concerns." While it is still to be seen, it seems possible that this loose language might instead create a zone of danger. Vertical mergers where the parties represent 20% or more of the market and the product is 20% of the market will be scrutinized, but those falling below these thresholds are still not safe from scrutiny.

Potential Anticompetitive Effects

The Draft Guidelines discuss several potential anticompetitive effects vertical mergers could create: foreclosure, raising rivals' costs, coordinated effects, and access to rivals' information. Where an upstream producer of the product and a downstream distributor merge, the Agencies are concerned about the potential for the merged entity to cut off the supply of the product to other non-merged parties ("foreclosure"), or the potential to raise the cost of that product for other non-merging parties. The result of foreclosure or raising prices could be that the non-merging distributors may raise costs on consumers, be deterred from entering or expanding in a market, lose sales, or be forced out of the market altogether. For instance, if a pharmaceutical manufacturer were to merge with a large chain pharmacy, it could either exclusively distribute medication through that pharmacy, thereby foreclosing access to it, or it could raise the price on that medication for other pharmacies (potentially claiming it can offer lower prices through its pharmacies because of reduced cost).

A related concern is that a vertical merger may result in coordination between the merged entity and other firms in the industry in a way that may harm consumers. One example would be to edge a maverick firm out of the market. A "maverick firm" is a firm that has greater economic incentive to deviate from its rivals and acts as an important check on those businesses. An example from a recent horizontal merger case is Grupo Modelo's Corona brand, the sales of which acts as a "check" on Anheuser-Busch and MillerCoors. With a greater share in the market for the upstream or downstream entity, the merged entity would potentially have greater ability to force out a maverick.

Finally, there is a concern about access to information from competitors. Entities often learn about the trade secrets, practices, or proprietary information about other entities at different levels in the supply chain. When entities at different levels of a supply chain merge, an entity would likely learn information about a competitor. For instance, when a media content distributor and a media content producer merge, the merged entity may know the business plans of distributors the producer formerly or currently works with. This would allow the merged entity to react to that plan in a way that harms the non-merging distributor.

Offsetting Efficiencies

The Draft Guidelines discuss that anticompetitive concerns from a vertical merger may be rebutted by evidence of efficiencies that protect competition and/or benefit consumers. Vertically merged entities may be able to streamline processes, lower costs, or otherwise benefit consumers. One such efficiency is the elimination of double marginalization. Where two entities charge a price that maximizes their profit margins merge, the integration may allow the merged entity to eliminate one of the margins while still achieving a profitable margin and lower price.

However, the elimination of double marginalization could potentially result in anticompetitive conduct if, as a result of the merger, the merged entity charged less for its product when distributed through it, but charged more to a non-merging distributor or ceased selling the product to the distributor at all.

Another potential issue is the standpoint where anticompetitive harm or procompetitive benefit is being evaluated. In the healthcare context, a reasonable person may assume it is from the perspective of the patient. However, courts have found that this is not always the case; rather effects of the merger could be looked at from the perspective of the insurance company who makes payment. Were a medical supply company to merge with a provider entity (e.g., a hospital), while the public may see procompetitive benefits from the vertical merger, it could still be seen as anticompetitive if it forecloses the market to a competitor medical supply company or raises costs on the insurance company.

Ultimately, the parties to the merger bear the burden (and the cost) of establishing any efficiencies that result from the merger and to demonstrate they outweigh anticompetitive concerns to overcome the prima facie case that the merger would have anticompetitive effect.

While recent cases in which the Agencies have challenged vertical mergers have been unsuccessful, the increased scrutiny itself is costly and may chill the desire to vertically merge. As the Agencies receive comments, they may likely revise the Draft Guidelines to provide greater clarity on how businesses can best avoid such scrutiny. Regardless of whether the Draft Guidelines are revised, it waits to be seen how courts interpret them and potentially prevent certain vertical mergers from moving forward.

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