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DOJ and FTC Issue Draft Vertical Merger Guidelines

Late Friday, the Department of Justice (DOJ) and Federal Trade Commission (FTC) issued draft vertical merger guidelines for public comment. The guidelines provide important insight for business people and their advisors into how the agencies are likely to analyze mergers involving firms at different levels of the supply chain. The guidelines describe potential anticompetitive harms that may arise with vertical mergers, while recognizing that they also "have the potential to create cognizable efficiencies that benefit competition and consumers." In issuing the draft guidelines, the agencies seek to provide transparency about the agencies' approach to vertical merger analysis. Comments are due by February 11, 2020. According to the press releases, "[t]he agencies will review and consider the public comments before issuing final Vertical Merger Guidelines." FTC Commissioners Chopra and Slaughter abstained from the Commission's vote to publish the draft guidelines for comment and issued statements.

In recent months, officials at both agencies said that they were working on the new guidelines. Prior guidance on vertical mergers was issued by the DOJ as part of the Department's 1984 Merger Guidelines. However, this guidance, which the DOJ formally withdrew with the publication of the draft of the new guidelines, has been viewed for some time as outdated and not reflective of the agencies' current approach to vertical mergers. Early last year, Assistant Attorney General for the Antitrust Division Makan Delrahim spoke about the competitive analysis of vertical mergers, and several principles he articulated then are reflected in the new draft guidelines.

Theories of Potential Harm from Vertical Mergers

The new draft guidelines describe ways in which a vertical merger might, in the agencies' view, have both harmful unilateral effects and harmful coordinated effects.

Unilateral Effects

With respect to unilateral effects, the guidelines state that a vertical merger may harm competition if it leads the newly integrated firm to raise its rivals' costs by, for example, charging them more for a required input for a product manufactured by the firms or, more severely, entirely forecloses a competitor's access to a necessary input. In these scenarios, the rival may be hindered in its ability to compete with the vertically-integrated firm and therefore may be less of a competitive constraint, which may cause prices for the end product to rise. The vertically-integrated firm may even gain sales that are diverted from its weakened rival, and this may offset any profits lost from decreased (or eliminated) sales of the input to its rival. By contrast, the 1984 guidelines posited that a vertical merger, under certain narrow circumstances, could harm competition by erecting barriers to entry for potential rivals by necessitating "two-level entry" into both

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upstream and downstream markets. The earlier guidelines also posited a theory that vertical integration could allow a company, such as a utility, to effectively evade rate regulation of a downstream product or service by raising the cost of an input. The absence of this concept from the new guidelines was cited by FTC Commissioners Chopra and Slaughter as a reason for their abstentions.

In addition to the raising rivals' costs and foreclosure theories, the new guidelines also recognize two ways in which potentially harmful unilateral effects may arise when a newly integrated firm becomes a supplier to a rival and gains access to that rival's competitively sensitive information. First, "[a]ccess to a rival's competitively sensitive information can . . . be used by the merged firm to moderate its competitive response to its rival's competitive actions, for example it may preempt or react quickly to a rival's procompetitive business actions. Under such conditions, rivals may see less competitive value in taking procompetitive actions." Second, "rivals may refrain from doing business with the merged firm rather than risk that the merged firm would use their competitively sensitive business information as described above," and therefore "[t]hey may become less effective competitors if they are forced to rely on less preferred trading partners, or if they pay higher prices because they have fewer competing options."

Importantly, the guidelines recognize that a vertical merger might actually lower prices by eliminating double marginalization. As the agencies describe it:

> Elimination of double marginalization can occur when two vertically related firms that individually charge a profit-maximizing margin on their products choose to merge. Absent the merger, the downstream merging firm would ignore any benefit to the upstream merging firm from setting a lower downstream price and making higher sales. But if the two merge, the resulting firm will benefit from both margins on any additional sales, and capturing the upstream margin, through merger, may make the price reduction profitable even though it would not have been profitable prior to the merger. Elimination of double marginalization may thus benefit both the merged firm and buyers of the downstream product or service.

According to the guidelines, the DOJ and FTC "will not challenge a merger if the net effect of elimination of double marginalization means that the merger is unlikely to be anticompetitive in any relevant market."

Coordinated Effects

The guidelines state that that a vertical merger may harm competition if it increases the likelihood of "postmerger coordinated interaction among firms" that harms consumers when, for example, a newly vertically-integrated firm gets access to rivals' competitively sensitive information and this "facilitate[s] (a) reaching a tacit agreement among market participants, (b) detecting cheating on such an agreement, or (c) punishing cheating firms."

Apart from the potential harms arising from access to a rival's competitively sensitive information, the new guidelines also outline a coordinated-effects theory of harm based on the potential for a vertically-integrated firm to thwart a "maverick firm that otherwise plays or would play an important role in preventing or limiting anticompetitive coordination in the relevant market."

Potential Safe Harbor

The guidelines are based on the concept of a "related product," which is defined as "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." The guidelines note that a "related product could be, for example, an input, a means of distribution, or access to a set of customers." The guidelines go on to state that if "the parties to the merger have a share in the relevant market of less than 20 percent, and the related product is used in less than 20 percent of the relevant market," then the merger is not likely to face a challenge by the agencies based on a vertical theory of harm. FTC Commissioner Slaughter cited this potential safe harbor as one of the reasons she abstained from the Commission's vote to issue the draft.

Significance

The issuance of new guidelines is an important development. Although not yet final, they provide executives, dealmakers and their advisors with insight into how the federal agencies are likely to evaluate a deal with vertical elements, whether a deal is likely to be challenged and how a court might analyze an agency challenge seeking to block a deal. Thus, they are a key tool to help assess the antitrust risk of a proposed transaction.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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