Editor's Note: Are the Vertical Merger Guidelines Ripe for Revision?

BY DEBORAH L. FEINSTEIN

IT HAS BEEN AN INTERESTING FIRST year of antitrust enforcement under the Obama administration. The Federal Trade Commission has continued to pursue aggressively both merger and non-merger matters. The Department of Justice has brought fewer actions than the FTC, but the pro-enforcement rhetoric continues unabated.

As promised, the agencies quickly issued a draft of revised Horizontal Merger Guidelines. That draft has drawn and will continue to draw significant controversy. Should the upward pricing pressure model be codified in the Guidelines? Do high margins really mean a likelihood of collusion or price-insensitive customers and, if so, what are the implications for mergers involving companies with high margins? Do the Guidelines imply that combining the companies' products inevitably reduces consumer choice? Despite the controversy, the Guidelines are likely, with few revisions, to be implemented and will guide merger enforcement and litigation going forward.

When the dust settles on the Horizontal Merger Guidelines, what will the agencies tackle next? One possibility is that they will draft revised Vertical Merger Guidelines for the first time in over twenty-five years. The ABA Section of Antitrust Law has in fact suggested additional guidance is necessary. In its responses to the questions accompanying the announcement of the Horizontal Merger Guidelines revision, the Antitrust Section wrote:

> The Agencies still investigate and from time to time challenge vertical mergers, but practitioners and businesses do not have any current guidance on how the Agencies will analyze such mergers. The Section encourages the Agencies to articulate their analytical approach to vertical mergers, potentially leading toward updated guidance, that reflects current economic theory and agency practice with respect to vertical mergers.[1]

Deborah L. Feinstein, Editorial Chair of ANTITRUST, *is a Partner at Arnold & Porter LLP where her practice focuses on representing merging parties before the FTC and DOJ. She recently represented PepsiCo in the vertical acquisition of its two largest bottlers.*

It is certainly debatable whether new guidelines are necessary. On average, fewer than one vertical merger is challenged each year. Those cases gain wide publicity and the agencies' analysis becomes well known. Vertical mergers are, like other mergers, very fact-specific. Guidelines that attempt to address all possibilities run the risk of being of little utility. In articulating the possible ways in which vertical mergers may pose competitive concerns, the agencies also risk overstating their intention of engaging in more enforcement.

In assessing whether new guidelines are necessary and what they might say, a brief look at the history of vertical merger enforcement is informative.

History of Vertical Merger Enforcement

Early Enforcement Against Vertical Mergers. The seminal Supreme Court case, *Brown Shoe Co. v. United States*,[2] is often cited for its discussion of how to define a product market, but is rarely remembered as involving a vertical merger. The Supreme Court explained the concern with vertical transactions:

> The primary vice of a vertical merger . . . is that, by foreclosing the competitors of either party from a segment of the market otherwise open to them, the arrangement may act as a "clog on competition" which "deprive[s] . . . rivals of a fair opportunity to compete."[3]

Although the theory of harm as set forth in *Brown Shoe* sounds much as it does today, its application to transactions that resulted in minimal levels of foreclosure has met with skepticism from the courts, and numerous vertical merger challenges were dismissed where, for example, the amount of foreclosure was low.

The 1984 Guidelines. The 1984 Guidelines were the last to include a discussion of vertical mergers. The relevant section was titled, "Horizontal Effect from Non-Horizontal Mergers," and covered both potential competition and vertical mergers.[4] Three basic competitive concerns arising from vertical mergers were addressed. First, the 1984 Guidelines noted that vertical mergers could create increased barriers to entry by requiring entry at two levels, which could result in entry being more costly and time-consuming. Second, they explained that vertical mergers could facilitate collusion by making it easier to monitor downstream retail prices. Third, vertical mergers could be of concern where they allowed a company to evade rate regulation. Interestingly, the word "foreclosure" does not appear anywhere in the 1984 discussion of vertical mergers, although that was the bedrock of the concern in *Brown Shoe* and clearly was underlying the concern that vertical mergers might result in two-level entry being required.

The 1992 Guidelines and the Aftermath. When the 1992 Guidelines were introduced, they explicitly referred only to Horizontal Mergers. The 1984 Guidelines' section on

Non-Horizontal Mergers remained technically in effect, but the agencies did not, when issuing the Horizontal Merger Guidelines in 1992, explicitly endorse the Non-Horizontal Merger Guidelines as the correct means of analyzing such transactions. And for a number of years after issuance of the 1992 Horizontal Guidelines, there were no noteworthy challenges to vertical mergers.

Enforcement against vertical mergers had a brief resurgence in the mid-1990s. At the time, the FTC brought actions against companies in a wide range of industries—TimeWarner Turner (telecom), Eli Lilly and Merck (pharmaceuticals), and Silicon Graphics (electronics). A 1995 speech by then-FTC Commissioner Varney explained her views on vertical mergers. She began by noting that "[v]ertical integration can lower transaction costs, lead to synergistic improvements in design, production and distribution of the final output product and thus enhance competition. Consequently, most vertical arrangements raise few competitive concerns."[5]

Commissioner Varney's speech cited and tracked the 1984 Guidelines' recitation of harms from vertical mergers. However, while couched in terms of how a vertical merger might increase barriers to entry, much of the discussion was about how "vertical integration can foreclose rivals from access to needed inputs or raise their costs of obtaining them." Thereafter, cases were brought from time to time, but there was little focus on vertical mergers.

The AMC Report. The April 2007 Antitrust Modernization Commission Report recommended, as part of an overall recommendation of greater transparency by the enforcement agencies, that the agencies update the Guidelines with respect to non-horizontal mergers.[6] Otherwise, there was no particular focus or concern about the treatment of non-horizontal mergers, or elaboration of the recommendation. Commissioner Don Kempf expressly disagreed with the recommendation:

> Updating the Merger Guidelines to cover . . . non-horizontal mergers . . . strikes me as a bad idea. . . . [T]hose are almost never challenged. For good reason. An effort to "explain" this carries with it the temptation to fashion "creative" new theories as to when such mergers can be anti-competitive and should be challenged. Again, it would be better to leave well enough alone and let "guidance," to the extent it is needed at all, develop in the context of actual proposed transactions and . . . with the assistance of the courts if need be."[7]

The Bush Department of Justice similarly disagreed with the AMC recommendation. Recognizing that "vertical mergers tend to promote efficiency by, for example, eliminating double marginalization," then Deputy Assistant Attorney General Gerald Masoudi expressed his view that "because vertical merger analysis is such a factbound exercise, and because the great majority of vertical mergers will be procompetitive, generating guidelines for vertical merger analysis may not be a productive exercise."[8]

Yet again, there was no move towards new vertical merger guidelines.

The EU Vertical Merger Guidelines. Meanwhile, across the Atlantic, vertical mergers were the subject of significant discussion. In late 2007, the European Commission adopted its Non-Horizontal Merger Guidelines, which included substantial discussion of the Commission's framework for analyzing horizontal mergers. The EU Guidelines recognize that "[n]on-horizontal mergers are generally less likely to significantly impede effective competition than horizontal mergers" and that such mergers "provide substantial scope for efficiencies."[9] These efficiencies include the "internalization of double mark-ups" which may "provide an increased incentive to seek to decrease prices and increase output," decreased transaction costs and the alignment of "incentives of the parties with regard to investments in new products, new production processes and in the marketing of products."[10]

The EU Guidelines also detail possible competitive concerns, focusing on the possibility of foreclosure, either at the input level or the customer level. They articulate a three-part test for assessing the likelihood of an anticompetitive foreclosure: whether the merged firm would have (1) the ability and (2) the incentive to foreclose; and (3) whether the foreclosure would have a "significant detrimental effect" on competition downstream. The EU Guidelines also point to the fact that vertical mergers can result in coordinated effects where a non-horizontal merger makes it significantly more likely for the merged firm and its rivals to coordinate and raise prices or otherwise harm competition.[11]

Current Enforcement Activity. Recently, both the FTC and DOJ have obtained consents in vertical transactions. In PepsiCo's acquisition of two of its largest bottlers, the FTC required a firewall to prevent information about Dr Pepper products, which the bottlers also distributed, from being shared with those on the concentrate side of PepsiCo's business. In Ticketmaster/LiveNation, the DOJ achieved divestitures and other relief to address the vertical aspects of that transaction.[12] The DOJ and FCC are currently investigating vertical issues that may arise from Comcast-NBC joint venture.

Should the Agencies Promulgate New Vertical Merger Guidelines?

There seems little doubt that the agencies' thinking on vertical mergers has moved beyond the 1984 Guidelines. Both then-Commissioner Varney's 1995 speech and a more recent speech by FTC Commissioner Rosch[13] focus on the risks of foreclosure from vertical mergers and note that such risks can occur even when they do not necessitate—at least in the immediate term—two-level entry. But those views have been clearly explained in speeches—and further thinking can be set forth in that manner as well. The resources that go into drafting and achieving consensus on new guidelines are extensive and may not be justified given the low rate of challenge to vertical mergers.

In the process of drafting new guidelines, the agencies inevitably focus more on the circumstances under which they will bring enforcement actions, rather than when they will not—a dangerous perspective in vertical transactions, where most are not only competitively neutral but in fact pro-competitive. If the agencies do draft new vertical merger guidelines, at least equal time and effort should be spent addressing the efficiencies that will be recognized and the benefits that may exist as is spent on the possible harms. The temptation to consider and address novel theories that might be more theoretical than real inevitably exists when drafting guidelines as the agencies try to give guidance on all the possible theories that could lead to an enforcement action. And given the relatively few enforcement actions undertaken by the agencies, it will be difficult to portray new guidelines as reflecting how current transactions are assessed rather than as being forward-looking pronouncements.

Finally, it is rare that vertical mergers end up being litigated in court. The remedies imposed in vertical mergers are in many respects far less standardized than the divestitures typically imposed in merger matters. They can range from basic information firewalls to provisions requiring non-discrimination all the way to divestitures to limit the degree of vertical integration. Any vertical mergers guidelines should include a section on the various means of remedying any competitive concerns arising from a vertical transaction. In this way, the agencies can provide adequate guidance but also allow vertical mergers, which are almost always pro-competitive, to proceed—and to proceed promptly. ■

1 ABA Section of Antitrust Law, *Comments of the ABA Section of Antitrust Law Regarding the Federal Trade Commission and Department of Justice Horizontal Merger Review Project* 4 (Nov. 9, 2009), *available at* http://www.ftc.gov/os/comments/horizontalmergerguides/545095-00010.pdf.

2 370 U.S. 294 (1962).

3 *Id.* at 323–24 (quoting Standard Oil Co. v. United States, 337 U.S. 293, 314 (1949), and H.R. Rep. No. 81-1191, at 8 (1949)).

4 *See* U.S. Dep't of Justice, 1984 Merger Guidelines § 4, *available at* http://www.justice.gov/atr/hmerger/11249.pdf.

5 Christine A. Varney, Commissioner, Fed. Trade Comm'n, Vertical Merger Enforcement Challenges at the FTC (July 17, 1995), *available at* http://www.ftc.gov/speeches/varney/varta.shtm.

6 Antitrust Modernization Commission, Report and Recommendations, Recommendation 11d, at 68 (2007), *available at* http://govinfo.library.unt.edu/amc/report_recommendation/amc_final_report.pdf.

7 *Id.* at 423 (Separate Statement of Commissioner Kempf).

8 Gerald F. Masoudi, Dep. Ass't Att'y Gen., U.S Dep't of Justice, Antitrust Division, Reflections on the Antitrust Modernization Commission Report and Recommendations (Sept. 5, 2007), *available at* http://www.justice.gov/atr/public/speeches/226045.htm.

9 Guidelines on the Assessment of Non-Horizontal Mergers under the Council Regulation on the Control of Concentrations between Undertakings, 2008 O.J. (C 265) 7, at ¶¶ 11, 13.

10 *Id.* ¶¶ 13, 57.

11 Three conditions are necessary for coordination to be sustainable: (1) the coordinating firms must be able to monitor to a sufficient degree whether the terms of coordination are being adhered to; (2) there is some sort of deterrent mechanism to discipline deviation; and (3) the reaction of outsiders (i.e., other current or future competitors or customers) should not be able to jeopardize the terms of coordination. *Id.* ¶¶ 79–81.

12 A further discussion of the Ticketmaster case is set forth in Jeremy Calsyn & Patrick Bock, *Merger Control Remedies: A More Flexible Administration?*, *supra* this issue at 15.

13 J. Thomas Rosch, Commissioner, Fed. Trade Comm'n, The Challenge of Non-Horizontal Merger Enforcement, Address at the Fordham Competition Law Institute's 34th Annual Conference on International Antitrust Law & Policy (Sept. 27–28, 2007), *available at* http://www.ftc.gov/speeches/rosch/070927-28non-horizontalmerger.pdf.