Hodgson Russ LLP ATTORNEYS

DOJ AND FTC PROPOSE VERTICAL MERGER GUIDELINES

Hodgson Russ Antitrust, Trade Regulation & Anticorruption Alert
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On January 10, 2020, the Federal Trade Commission and the United States Department of Justice Antitrust Division (the Agencies) proposed draft vertical merger guidelines (Vertical Guidelines). The Vertical Guidelines will be open for public comment until February 11, 2020, and after consideration of such comments, the Agencies will issue a final version.

As used by the Agencies, "vertical" refers to "firms or assets that operate at different stages of the same supply chain"; i.e. a manufacturer acquiring a supplier of inputs or a distributor of the manufacturer's finished products. In the Vertical Guidelines, "downstream" refers to the party in the supply chain closer to consumers or end users, and "upstream" those parties father from such stage.

The last vertical merger guidance was provided by the Agencies in 1984, and the current proposal has been long anticipated by antitrust practitioners and the business community alike. The Agencies have been highly active in recent years in the enforcement of applicable antitrust law in the context of vertical mergers, including the AT&T/Time Warner challenge (a notable defeat for the DOJ Antitrust Division), as well as Staples' proposed acquisition of wholesale distributor Essendant (completed in 2019, but subject to ongoing conduct restrictions limiting distribution of competitively sensitive information in the merged companies), CVS/Aetna merger (completed in 2019, subject to a mandatory divestiture) and Cigna/Express Scripts (cleared after a Second Request investigation).

Similar to the Agencies' other antitrust guidelines (i.e. the Horizontal Merger Guidelines, Guidelines for Competitor Collaborations, etc.), the final Vertical Guidelines will not be binding on any court or tribunal or, for that matter, the Agencies themselves. However, in practice the Draft Guidelines are likely to become a critical tool in analyzing any proposed acquisition involving vertically-related parties and the standards they enumerate are likely to work their way into pleadings and eventual court decisions.

The Draft Guidelines are designed to be read alongside the 2010 Horizontal Merger Guidelines (the HMG). While the HMG apply to mergers involving competitive parties at the same level in the supply chain, the new Guidelines will apply to parties at different levels. Many principles related to merger analysis, including relevant markets and products, translate easily between the two frameworks.

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Market Share Safe Harbor

According to the Vertical Guidelines, the Agencies are unlikely to challenge a vertical merger where the parties to the merger have a share in the relevant market of less than 20%, and the related product is used in less than 20% of the relevant market.

The HMG focus on "relevant markets" is an analysis of the competitive effects of a merger. In the vertical context, the Agencies add the concept of a "related product," referring to a product or service that is supplied by the merged firm, and is vertically related to the products and services in the relevant market. A related product "could be, for example, an input, a means of distribution, or access to a set of customers."

Many commentators have referred to this 20% threshold as a "safe harbor." However, the Vertical Guidelines are clear that mergers with shares below the thresholds may give rise to competitive concerns, particularly if a related product is relatively new and its share of use, while currently below 20%, is rapidly increasing. Additionally, vertical mergers involving firms with greater than 20% share are not automatically subject to additional scrutiny.

Vertical Mergers and the Potential for Anticompetitive Effects

Perhaps more helpful in understanding the given risk of a transaction, the Vertical Guidelines identify common means by which competitive harm may result from the unilateral or coordinated effects of a vertical merger.

Unilateral Effects -- Foreclosure and Raising Rivals' Costs. A merged firm may gain a significant post-merger advantage by gaining control over a related product essential to its competitor. For example, a manufacturer, Company A, acquires a key input supplier, Company B. Pre-merger, Company B supplied its input products to Company A and a number of Company A's competitors. Post-merger, Company A may impede its competitors' access to those inputs by raising prices, reducing quality or simply refusing to supply the input products all together. As a result, Company A's competitors may face increased costs or lack of ability to compete, reducing the competition for Company A in the downstream market. As a result, the vertical merger of Company A and Company B may lead to higher prices for consumers of Company A's products.

The Agencies' main considerations in this situation are: (1) whether the competitors to Company A identified above could lose sales as a result of Company A's actions, (2) whether Company A's business would benefit, (3) capturing this benefit through a merger makes the additional activity profitable, where it would not have been absent the merger and (4) the likely foreclosure or increase in rivals' costs would substantially lessen competition.

Unilateral Effects -- Access to Competitively Sensitive Information. A combination of two firms at different levels of the supply chain may permit access to sensitive business information about upstream or downstream rivals that was unavailable to the separate firms pre-merger. Using the prior example, Company A could access Company B's records on purchases by Company A's competitors, including quantity and cost information that could give Company A insight into its competitors' businesses. Those competitors may refrain from doing business with the post-merger Company A and B, which could again make such competitors less effective rivals of Company A.

Coordinated Effects -- Enabling Post-Merger Coordinated Interaction. A vertical merger may enhance a market's vulnerability to coordination by eliminating or damaging a maverick firm that would otherwise prevent coordination. Additionally, a merged firm's access to competitor information may facilitate collusion by allowing one of the colluding parties to detect

cheating.

Vertical Mergers and Procompetitive Effects

Of course, pro-competitive effects may also occur and the Agencies will take these effects into account in its analysis.

Elimination of Double Marginalization. Where firms at different levels of the supply chain merge, they were likely previously each imposing a margin in exchange for its activities, one of which may be eliminated or reduced as a result of the transaction. If the net effect of this double marginalization elimination yields lower prices for downstream market participants, this may be a powerful argument for permitting the transaction to proceed.

Efficiencies. Vertical mergers have the ability to increase coordination at different levels of the supply chain, permitting streamlining of production, inventory, and/or logistics, or creating new innovations that may have been impossible absent the combination. Agencies will view evidence of these types of resulting efficiencies favorably in their analysis of the proposed transaction.

If you have any questions concerning the Vertical Guidelines, the Agencies' approach to mergers in this context, or any other antitrust issues, please contact Valerie Stevens (vstevens@hodgsonruss.com).

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