GIBSON DUNN

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U.S. DEPARTMENT OF JUSTICE AND FEDERAL TRADE COMMISSION FINALIZE VERTICAL MERGER GUIDELINES

To Our Clients and Friends:

On June 30, 2020, the Federal Trade Commission and the Antitrust Division of the U.S. Department of Justice released new Vertical Merger Guidelines, which replace the Non-Horizontal Merger Guidelines published in 1984. The FTC's vote to issue the Guidelines was 3-2, with Commissioners Rebecca Kelly Slaughter and Rohit Chopra dissenting. The new Vertical Merger Guidelines are effective immediately.

Vertical mergers are M&A transactions that combine firms or assets operating at different stages of the supply chain. Examples of vertical mergers include a car manufacturer acquiring the company that supplies it with auto parts, or a grocery store acquiring a milk processor. The Vertical Merger Guidelines aim to describe the agencies' current approach to vertical mergers and provide greater transparency about how they evaluate such deals.

The finalized Guidelines include substantial revisions to previously released draft guidelines in response to more than 70 public comments. The Vertical Merger Guidelines acknowledge certain procompetitive benefits of vertical mergers, noting that vertical deals "often benefit consumers" by increasing incentives to lower prices and tend to raise fewer competitive concerns than horizontal mergers between competitors. But the final Vertical Merger Guidelines also remove from the initial draft what some observers viewed as a "safe harbor" and describe several additional ways in which vertical mergers could harm competition. And they leave several questions unresolved, including about remedies for vertical mergers.

Significant Changes from the Draft Guidelines

- **Market Share:** One notable change to the final Vertical Merger Guidelines compared with the draft guidelines is the removal of a "safe harbor" for certain transaction based on market shares. The agencies previously said they were unlikely to challenge a vertical merger where the parties to the merger have less than a 20 per cent share in the relevant market and the "related product" (a product or service supplied to firms in the relevant market by the merged firm) is used in less than 20 per cent of the relevant market. The agencies removed this provision following widespread criticism. Now, the Guidelines state that, though levels of concentration may be relevant to assessing a deal's competitive effects, the agencies will not rely exclusively on market shares or concentration statistics as screens for competitive harm.

- **Elimination of Double Marginalization:** The draft guidelines explained that when two vertically related firms merge, the merged firm can often profitably reduce its downstream prices by combining its upstream and downstream margins. The final Vertical Merger Guidelines

continue to stress the consumer benefits from this effect, called elimination of double marginalization ("EDM"), but elaborate on the agencies' approach to EDM in three ways. First, they explain that the agencies will consider EDM earlier in the analytical process, in assessing whether the merged firm would have an incentive to raise or lower prices as a result of the merger. Second, they suggest that parties will be expected to substantiate claims that their merger will produce EDM. And third, they explain that the agencies will address whether EDM is merger-specific by looking at the merged firms' cost of self-supply and its existing contracting practices.

- **Foreclosure and Raising Rivals' Costs:** Like the draft version, the final Guidelines emphasize that vertical mergers may harm competition by increasing the merged firm's incentive and ability to foreclose rivals from, or raise rivals' costs to access, related products such as necessary inputs or distribution channels. The Guidelines clarify, however, that mergers will "rarely warrant close scrutiny" on such grounds when rivals could readily switch to alternative providers of the related product, or supply themselves. And as already noted, the Guidelines now explain that the agencies will consider whether the merged firm's incentive to set lower downstream prices as a result of EDM offsets potential price increases from foreclosing rivals or raising their costs.

- **Complement and "diagonal" mergers:** The Guidelines now describe the agencies' approach to two types of mergers that, while not strictly vertical, bear similarities to vertical mergers. First, they explain that mergers between makers of complements, such as necessary components of the same product, can raise competitive concerns. Because the price of one complement in certain cases might affect demand for the other, a merged firm may harm rivals by raising the price of one input to customers that do not buy the other. However, the Guidelines acknowledge that mergers involving complementary products and services can also lead to lower prices and other consumer benefits. Second, the Guidelines describe possible competitive concerns that might arise in "diagonal" mergers—mergers between firms at different stages of competing supply chains. In certain cases, such mergers might raise competitive concerns by giving the merged firm control over inputs that facilitate competition between the different supply chains.

- **Entry:** The final Vertical Merger Guidelines also revive the "two-level entry" theory of harm, which also appears in the 1984 Guidelines. First, the agencies suggest that vertical mergers may harm competition by creating a need for "two-level entry." A vertically integrated company (according to the Guidelines) may have little incentive to encourage the entry of new upstream or downstream competitors, which may mean a new entrant has to self-supply, making entry more costly. Second, the Guidelines state that the agencies will consider whether a vertical merger harms competition by forestalling the potential entry of one merging party into the other firm's market.

Analysis and Implications

Changes to the final Guidelines attempt to address comments from multiple directions and perspectives. Merging parties will welcome the Guidelines' greater emphasis on and recognition of the procompetitive benefits of many vertical mergers—EDM foremost among them. The Guidelines now also helpfully describe situations in which vertical mergers will rarely raise concerns about foreclosure or raising rivals'

costs. At the same time, advocates for more active antitrust enforcement will be pleased that the final Guidelines lack a safe harbor and describe additional ways in which a vertical merger could potentially harm competition, including by discouraging potential entry and through "diagonal" and other relationships.

Still, several areas of uncertainty remain from the draft guidelines, and present potential ambiguities for merging parties.

For instance, the Guidelines resurrect the "two-level entry" theory of harm, asserting that vertical mergers can raise barriers to entry by effectively requiring new rivals to simultaneously enter both the upstream and downstream markets. Although the 1984 Guidelines also explored this theory, it is unclear whether "two-level entry" has ever provided a standalone basis for challenging a merger, and the agencies' draft guidelines would have eliminated it.

The elimination of the safe harbor also creates uncertainty about how market shares and concentration will factor into the agencies' approach to vertical mergers. The draft Guidelines contained language suggesting that enforcement action was unlikely for mergers below certain market share thresholds, while holding out the possibility that mergers with shares below the thresholds could still give rise to competitive concerns. But with the safe harbor gone, parties now have little insight into how the agencies will factor the merged firms' market shares and concentration into their analysis, other than knowing that "high" concentration may sometimes cause concerns.

How the agencies will approach EDM in practice also remains unclear from the final Guidelines. The Guidelines at times appear to suggest that merging parties have the burden of showing that EDM is verifiable and merger specific, as with efficiencies under the Horizontal Merger Guidelines. But elsewhere, the Guidelines suggest that the agencies may "independently attempt to quantify" EDM based on available evidence, including the evidence agencies develop themselves to assess other price effects.

Lastly, the Guidelines remain silent about how the agencies will address remedies in vertical mergers. Recent policy statements and the retraction of DOJ's 2011 Policy Guide for Merger Remedies have created considerable uncertainty about the agencies' approach. For example, it is unclear whether either or both agencies will seek structural remedies in the form of divestitures, or will continue to accept conduct or "behavioral" remedies as they have in the past. It remains to be seen whether or how the new Guidelines will impact agency policy concerning remedies.

Companies considering vertical mergers should carefully consider whether their transactions will receive increased scrutiny under the new Vertical Merger Guidelines. Gibson Dunn successfully defended the only vertical merger challenge litigated to trial by the DOJ in the last forty years (involving AT&T's acquisition of Time Warner), and attorneys in our Antitrust and Competition Law practice stand ready to assist clients in analyzing and securing approval of vertical transactions.

The following Gibson Dunn lawyers prepared this client alert: Kristen Limarzi, Adam Di Vincenzo, Richard Parker, Chris Wilson and Harry Phillips.

Gibson Dunn's lawyers are available to assist in addressing any questions you may have regarding these developments. Please feel free to contact the Gibson Dunn attorney with whom you usually work, the authors, or any member of the firm's Antitrust and Competition Practice Group:

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