

Federal Trade Commission Releases Commentary on Vertical Merger Enforcement

WRITTEN BY

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Split along partisan lines, the Federal Trade Commission (Commission) voted last week to issue Commentary on Vertical Merger Enforcement (Commentary). The Commentary intends to “provide[] greater transparency to the public regarding [the Commission’s] analysis of vertical mergers” by collecting in a single document the Commission’s past vertical merger cases and summarizing how it has analyzed potential anticompetitive effects in vertical transactions.^[1]

The two Democratic commissioners dissented here just as they had in June 2020, with respect to the issuance of the Vertical Merger Guidelines (Guidelines) themselves.^[2] Here, the dissenting commissioners caution against relying on the past to assess how the agency will, in the future, treat transactions that include a non-horizontal element,^[3] while the Republican majority points out that the Democrats dissent “not because they quibble with the faithfulness of the Commentary’s recounting of the history of vertical merger enforcement, but because they object to the history itself.”^[4] The majority appears frustrated by their dissenting colleagues’ criticism of vertical merger analysis without any explanation of how they would address the challenges created by the existing case law and of litigating without economic models and theory previously accepted in this area.

Even in the face of a change in administration, the Commentary provides a helpful resource for parties considering vertical transactions. Moreover, the Guidelines and the Commentary remain relevant and important because, absent a Republican resignation, the current Republican majority will retain control until 2023.

The Commentary

The Commentary seeks to provide greater transparency about the way the Commission analyzed non-horizontal mergers. Non-horizontal mergers include (1) purely vertical transactions, where firms at different levels of the supply chain combine; (2) diagonal transactions, which are combinations of firms at different stages of competing supply chains; (3) mergers of suppliers of complementary products; and (4) transactions with both vertical and horizontal elements, such as where at least one of the parties is already vertically integrated and seeks to acquire a firm that is its competitor in one market and a customer or supplier of a related product. The Commentary also discusses the potential for vertical mergers to eliminate future horizontal competition by weakening the incentive for a party to enter an upstream or downstream market.

The Commentary describes the potential anticompetitive effects and procompetitive benefits that can arise in these various non-horizontal transactions and helpfully compiles the transactions, where such concerns were previously investigated by Commission staff.

Anticompetitive Effects

When reviewing a vertical merger, the agency evaluates both the potential unilateral and coordinated effects. With respect to unilateral effects, the Commentary, like the Guidelines, highlights potential harms that arise in vertical transactions: (1) foreclosure and raising a rival's costs and (2) sharing competitively sensitive information.

Regarding the first concern, the Commentary outlines three factors that the agency used to evaluate whether the merger will weaken or remove a competitor from the market by raising a rival's costs or by refusing to supply the products altogether (*i.e.*, foreclosure): (1) whether the merged firm has the ability to cause the rival to lose sales or compete less effectively; (2) whether the merged firm has the incentive to raise a rival's cost or foreclose a rival because it would benefit from the rival's lost sales; and (3) the effect of the merged firm on a rival's costs.

The agency also analyzes whether the potential to raise the costs or foreclose a future rival would make it more difficult for potential competitors to enter a market. In assessing this issue, the agency considers whether a potential competitor would need to enter at both levels of the supply chain to compete against the merged firm. One of the many examples included in the Commentary involves the agency's challenge of the merger of UnitedHealth and a large managed care provider organization. There, the agency was concerned that the merged entity could have impacted rival Medicare Advantage insurers in the Las Vegas area by raising their costs for or foreclosing them from the two largest managed care provider organizations (one of which was being acquired in the proposed transaction).

The second concern — whether post-merger the combined entity may gain access to sensitive business information about its competitors — has historically been addressed with behavioral remedies, such as firewalls. The specific harm to competition that could arise from access to information includes (1) a rival being less inclined to take competitive actions if the merged entity knows its plans and responds, or (2) a rival ceasing to do business with the merged entity and incurring higher costs as a result. The Commentary provides the Staples/Essendant combination as an example. There, Staples acquired Essendant, the largest distributor of office supplies, and the agency was concerned that Staples would gain access to information about Essendant's customers, which competed against Staples. Information about these competitors could cause Staples to bid higher to end customers than it would have absent the information.

With respect to potential coordinated anticompetitive effects, the Commentary explains that a vertical transaction may increase the likelihood that the combined entity will coordinate with rivals to the detriment of customers. This harm could result from eliminating or hobbling a maverick firm that constrains other firms from coordinating or from the merged entity's access to competitors' sensitive information that could facilitate collusion. The Commentary used as an example a pharmaceutical manufacturer's acquisition of a pharmacy benefit manager (PBM). There, the agency expressed concern that removing an independent PBM could lead to less discounting and more coordination by drug manufacturers.

Potential Procompetitive Effects

The Commentary also recognizes that vertical mergers can achieve procompetitive benefits and that these potential procompetitive effects should be considered when evaluating a potential transaction. Two such potential procompetitive effects are the elimination of double marginalization (EDM) and efficiencies. Prior to a merger, the

upstream entity may mark up its price to the downstream entity to achieve a profitable margin. The downstream entity then, in turn, charges an additional mark up to consumers to achieve a profitable margin. Thus, the consumer pays for both markups, also called double marginalization. With a vertical merger, the markup between the upstream entity and downstream entity may be eliminated, and the merged entity may then charge lower prices to end consumers to achieve greater sales. At the same time, the Commentary cautions that there will be no EDM if the inputs of the upstream firm cannot be used by the downstream firm or if the downstream firm already self-supplied the inputs. As an example of a transaction involving EDM, the Commentary describes the agency's investigation of the merger of Essilor, a manufacturer of lenses, with Luxottica, a frame producer. The agency observed that, with the combination, Luxottica would pay less for lenses upstream and thus could offer its glasses at lower prices downstream at retail outlets.

Takeaways

As the economic literature evaluating non-horizontal transactions continues to evolve and uncertainty exists regarding the strength of current economic models to assess the effects of such transactions, the agencies' approach to such transactions may also evolve. In conjunction with the Guidelines released this summer, the Commentary provides helpful explanations and examples for understanding how the Commission may view transactions with vertical elements.

Unless one of the Republican commissioners resigns early, as the chart below reflects, the next opening for a new commissioner, who could change the party alignment of the Commission, is not until September 2023.

| Commissioners | Party Affiliation | Expiration of Term |
|-------------------------|--------------------------|---------------------------|
| Joseph J. Simons, Chair | Republican | September 25, 2024 |
| Noah Joshua Phillips | Republican | September 25, 2023 |
| Christine S. Wilson | Republican | September 25, 2025 |
| Rebecca Kelly Slaughter | Democrat | September 25, 2022 |
| Rohit Chopra | Democrat | September 25, 2019 |

Accordingly, firms must continue to evaluate their transactions as they would have under a Republican administration. Therefore, when considering a vertical merger, it is important to consult these documents and to analyze the following questions:

- What are the parties' shares in their respective markets and in what portion of the downstream markets are their products used?
- Will the upstream entity increase the prices of input products to competitors of the downstream entity, or will it refuse to sell the input product to these competitors altogether?
- What other options do rivals of the downstream entity have to source the inputs sold by the upstream entity?
- Do the merging parties have plans to eliminate double marginalization and reduce prices?
- Do the merging parties believe that efficiencies will be achieved through the combination that will benefit consumers?

- Have contemporaneous business documents been created that show the merging parties' assessment of the impacts of double marginalization and efficiencies?
 - Can information firewalls or other measures be established to ensure that the merged entity does not misuse sensitive information of its rivals made accessible by the transaction?
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[1] Fed. Trade Comm'n, Commentary on Vertical Merger Enforcement, Dec. 2020, *available* [here](#).

[2] U.S. Dep't of Justice and Fed. Trade Comm'n, Vertical Merger Guidelines, June 30, 2020, *available* [here](#). When the Guidelines were issued, their dissents raised several concerns, but the primary one was that the Guidelines continue to over emphasize the potential benefits of non-horizontal transactions and would be used by the enforcement agencies to continue their historic level of scrutiny, instead of the more rigorous or aggressive approach favored by the Democratic commissioners. Dissenting Statement of Commissioner Rohit Chopra Regarding the Publication of the Vertical Merger Guidelines, June 30, 2020, *available* [here](#) and Dissenting Statement of Commissioner Rebecca Kelly Slaughter In Re FTC-DOJ Vertical Merger Guidelines, *available* [here](#).

[3] Joint Dissenting Statement of Commissioners Rohit Chopra and Rebecca Kelly Slaughter, Regarding the Vertical Merger Commentary, Dec. 22, 2020, *available* at [Joint Dissenting Statement of Commissioners Chopra and Slaughter Regarding the Vertical Merger Commentary \(ftc.gov\)](#).

[4] Statement of Commissioners Noah Joshua Phillips and Christine S. Wilson, Commentary on Vertical Merger Enforcement, *available* [here](#).

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