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Silicon Valley Should Prepare To Defend Diagonal Mergers

By **James Fishkin and Dennis Schmelzer** (July 29, 2020, 3:41 PM EDT)

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On June 30, the U.S. Department of Justice and the Federal Trade Commission released final vertical merger guidelines that, for the first time, introduce the concepts of "diagonal mergers" and "mergers of complements" into the U.S. antitrust lexicon.

At first glance, these changes might simply look like an afterthought added in response to public comments.

There are reasons, however, for Silicon Valley to pay attention to this change. Far from a minor clarification, the new diagonal merger construct in particular may signal a new area of focus for the agencies.

As defined by the vertical merger guidelines, diagonal mergers are those that combine firms or assets at different stages of competing supply chains.[1] For example, a diagonal merger would include a manufacturer of laptop computers acquiring a manufacturer of components only designed for desktop computers. These companies are neither horizontal competitors nor located in the same vertical supply chain. To the extent that laptop computers compete with desktop computers, however, such a merger could still raise competitive concerns.

Unlike conventional vertical mergers, diagonal mergers may attract more attention than other vertical mergers for one key reason: The agencies are less likely to credit perceived efficiencies and pro-competitive benefits.

Many tech industry mergers today might fit into the framework of diagonal mergers. Taking the vertical merger guidelines at face value, the agencies appear more likely to investigate and challenge those mergers in the years ahead.

New Guidelines May Provide Insights Into Agency Views on Big Technology

Merger guidelines in U.S. are not binding law and are primarily intended to explain and clarify current agency practices for evaluating mergers rather than signify any policy shifts.

The goal of the guidelines is to provide greater transparency around the principal analytical techniques,

practices and enforcement policies for evaluating a wide range of transactions. In principle, the factors outlined in the guidelines should closely track existing case law and economic theory, which serve as independent constraints on the agencies and their analysis.

At the same time, the vertical merger guidelines certainly were not just an academic exercise prepared in a vacuum. The DOJ first announced that joint vertical guidelines were underway in March 2019,[2] which immediately followed the DOJ's loss at trial in June 2018 and on appeal in February 2019 in the AT&T Inc.-Time Warner Inc. case,[3] the first vertical merger litigated by the agencies in four decades.

Indeed, the U.S. Court of Appeals for the D.C. Circuit specifically noted in that case that "[t]here is a dearth of modern judicial precedent on vertical mergers and a multiplicity of contemporary viewpoints about how they might optimally be adjudicated and enforced," adding that "[t]he government's guidelines for nonhorizontal mergers were last updated in 1984, over three decades ago."[4]

This high-profile judicial acknowledgment that the prior guidelines were outdated may have been enough to push the agencies into action with the new guidelines.

The agencies also have focused considerable attention in recent years on rethinking how the antitrust laws apply to large technology firms. In July 2019, for example, the DOJ announced it was investigating "whether and how market-leading online platforms have achieved market power and are engaging in practices that have reduced competition, stifled innovation or otherwise harmed consumers."[5]

This followed the FTC's launch of a technology task force to monitor competition in U.S. technology markets in February 2019[6] and it preceded the FTC's decision in February 2020 — about a month after the draft vertical guidelines were released — to issue special orders to a number of leading technology companies to produce information and documents about all transactions consummated in the last 10 years that were not previously reported to the antitrust agencies.[7]

Those special orders were explicitly intended to "contribute broadly to the FTC's understanding of technology markets, and thereby support the FTC's program of vigorous and effective enforcement to promote competition and protect consumers in digital markets."[8]

In some ways, the DOJ's vertical challenge of the AT&T-Time Warner merger could be seen as part of this evolution in agency views on high technology. After all, while AT&T and Time Warner were traditional market leaders in their own business areas, the merging parties claimed that together they would build a "[n]ew company with complementary strengths to lead the next wave of innovation in [a] converging media and communications industry."[9]

These bold claims drew attention to how the combination would impact rivals and consumers in the quickly evolving marketplace for digital content and services. In this way, the DOJ's challenge was reminiscent of an earlier wave of challenges brought against leading high-tech and media combinations that similarly promised to transform the media landscape more than two decades ago.[10]

Of course, the DOJ's willingness to challenge deals in evolving markets has not been limited to AT&T-Time Warner. More recently, the DOJ unsuccessfully sought to block Sabre Corp. from acquiring Farelogix Inc. because of concerns that Sabre, as a dominant firm, was trying to "take out a disruptive competitor that has been an important source of competition and innovation," which "would likely result in higher prices, reduced quality, and less innovation for airlines and, ultimately, traveling

American consumers."[11]

In Sabre-Farelogix, the DOJ pursued a purely horizontal theory of harm that depicted Farelogix as a nascent Sabre competitor. The DOJ struggled, however, to show how Farelogix, which only provides IT solutions to airlines, was a horizontal competitor with Sabre, a global distribution system that operates a platform designed to connect a large number of travel suppliers, including airlines, hotels and car rental companies with a large number of travel agencies.[12]

The DOJ attempted to bridge this gap by defining a proposed booking services product market that included similar services offered by the companies, but the district court rejected that approach, finding that DOJ's expert economist could not identify basic features of the product, including the price or value of the booking services offered by either Sabre or Farelogix.[13]

Given these difficulties with its horizontal challenge, good arguments could be made that the DOJ might have fared better with a vertical challenge.[14]

With agency views on digital markets clearly evolving in recent years, it is worth reading the tea leaves to see what new information might be obtained from the vertical merger guidelines.

After Recent Setbacks, Diagonal Mergers May Signal New Area of Focus

Especially because guidelines are not supposed to signal policy shifts, the addition of two new terms to the vertical merger guidelines — "diagonal mergers" and "mergers of complements" — should raise eyebrows among practitioners.

These terms are not generally familiar to the U.S. antitrust bar[15] and they were entirely omitted from the draft guidelines released for public comment in January 2020. Similarly, diagonal mergers were not discussed at the FTC's November 2018 hearing on vertical merger analysis featuring government officials, academics and practitioners.[16] They also have not previously been discussed by agency officials in speeches or prepared remarks or referenced in prior enforcement actions.[17]

Diagonal mergers and mergers of complements, however, are not entirely new concepts. Instead, these terms appear to have been borrowed from the merger assessment guidelines in the United Kingdom, which introduced similar concepts for assessing combinations that were neither vertical nor horizontal back in 2010.[18]

These terms fit into a longer discussion of diagonal mergers in Europe regarding products that do not compete but are part of supply chains that are considered "substitutes in an indirect sense."[19] Much of this discussion relates to the tech industry, with Google LLC-DoubleClick Inc. commonly described as an example of a diagonal merger.[20]

In the U.S., the precise theory of harm from diagonal mergers is not detailed in the new vertical merger guidelines but the agencies illustrate that theory through an example in which a company acquires control over an input that it does not use in its own products but which is important to its potential competitors.[21]

Because the buyer does not rely on the input for its own products, the example concludes that the merger would create fewer pro-competitive benefits: "The incompatibility between the technologies of the merging firms strongly suggests that this merger is unlikely to generate any benefits due to the

elimination of double marginalization."[22]

This suggestion that diagonal mergers are unlikely to generate benefits from the elimination of double marginalization strongly contrasts with other language in the guidelines acknowledging that "vertical mergers often benefit consumers through the elimination of double marginalization, which tends to lessen the risks of competitive harm."[23] The clear implication is that the agencies do not believe diagonal mergers are likely to achieve the same significant efficiencies as other vertical mergers.

This view that diagonal mergers have fewer, if any, redeeming efficiencies is consistent with how diagonal mergers are often viewed in Europe. One treatise, for example, notes diagonal mergers are frequently described as "input foreclosure without the efficiency."[24]

Since the guidelines acknowledge significant potential efficiencies from most vertical mergers, it stands to reason that the agencies are more likely to pursue challenges of potentially anticompetitive mergers perceived to lack those benefits — namely, diagonal mergers.

In that regard, the agencies may be looking directly at Silicon Valley. Mergers that defy horizontal and vertical characterizations are increasingly common in the tech space. For startups in particular, the DOJ recognizes that "a popular exit strategy is acquisition by a large firm in the same or an adjacent market."[25] With diagonal mergers, the agencies appear focused on these types of acquisitions in adjacent markets, where the target is seen as extending the buyer's existing business into new but related business areas.

As shown by Sabre-Farelogix, the DOJ has struggled with horizontal challenges intended to protect nascent competition from new technologies viewed as potential substitutes to more established market players. Diagonal mergers may be the agencies' new theoretical solution to this problem.

As they pursue investments in adjacent markets, technology companies should prepare to defend the asserted efficiencies driving those transactions. For transactions that have both vertical and diagonal elements, buyers should be prepared to demonstrate how the transactions are more vertical than diagonal if they seek to rely upon the acknowledged pro-competitive benefits from vertical mergers. Defining the precise slope of a merger may be critical to getting a deal done.

Finally, buyers should be prepared to explain why their transactions will not cut off rivals from critical inputs or significantly raise their rivals' costs. There once was a time when such diagonal mergers may have flown under the radar with little scrutiny. If the vertical merger guidelines are any guide, those transactions are likely to find a less receptive audience in the years ahead.

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[1] Vertical Merger Guidelines at 1.

[2] Press Release, U.S. Department of Justice, Department of Justice And Federal Trade Commission Issue New Vertical Merger Guidelines (Jun. 30, 2020).

[3] United States v. AT&T Inc., 310 F. Supp. 3d 161 (D.D.C. 2018), aff'd, 916 F.3d 1029 (D.C. Cir. 2019) [hereinafter AT&T/Time Warner].

[4] AT&T/Time Warner, 916 F.3d at 1037.

[5] See Press Release, U.S. Department of Justice, Justice Department Reviewing the Practices of Market-Leading Online Platforms (Jul. 23, 2019), https://www.justice.gov/opa/pr/justice-department-reviewing-practices-market-leading-online-platforms.

[6] Press Release, U.S. Federal Trade Commission, FTC's Bureau of Competition Launches Task Force to Monitor Technology Markets (Feb. 26, 2019), https://www.ftc.gov/news-events/press-releases/2019/02/ftcs-bureau-competition-launches-task-force-monitor-technology. On October 1, 2019, the FTC announced the conversion of the Technology Task Force into a permanent division in the Bureau of Competition. See Patricia Galvan and Krisha Cerilli, What's in a Name? Ask the Technology Enforcement Division (Oct. 16, 2019), https://www.ftc.gov/news-events/blogs/competition-matters/2019/10/whats-name-ask-technology-enforcement-division.

[7] Press Release, U.S. Federal Trade Commission, FTC to Examine Past Acquisitions by Large Technology Companies (Feb. 11, 2020), https://www.ftc.gov/news-events/press-releases/2020/02/ftc-examine-past-acquisitions-large-technology-companies.

[8] Id.

[9] Press Release, AT&T Corporation, AT&T to Acquire Time Warner (Oct. 2016), https://about.att.com/story/att_to_acquire_time_warner.html.

[10] See, e.g., Press Release, U.S. Federal Trade Commission, FTC Requires Restructuring of Time Warner/Turner Deal: Settlement Resolves Charges that Deal Would Reduce Cable Industry Competition (Sept. 12, 1996) (imposing conditions on merger of the largest cable provider with media content creators); Press Release, U.S. Federal Trade Commission, FTC Approves AOL/Time Warner Merger with Conditions (Dec. 14, 2000) (imposing conditions on a combination of the largest internet service provider with a media conglomerate), https://www.ftc.gov/news-events/press-releases/2000/12/ftc-approves-aoltime-warner-merger-conditions.

[11] Press Release, U.S. Department of Justice, Justice Department Sues to Block Sabre's Acquisition of Farelogix (Aug. 20, 2019), https://www.justice.gov/opa/pr/justice-department-sues-block-sabres-acquisition-farelogix.

[12] United States v. Sabre Corp., Civil Action No. 1:19-cv-01548-LPS at 12-13, 20-23 (D. Del. Apr. 8, 2020), vacated, case no. 20-1767 (3d Cir. Jul. 20, 2020).

[13] Id. at 75-76.

[14] James Fishkin & Dennis Schmelzer, Dechert LLP, A Vertical Challenge May Have Fared Better in Sabre Merger, Law360 (May 20, 2020), https://www.law360.com/articles/1274859/a-vertical-challenge-may-have-fared-better-in-sabre-merger.

[15] One exception is Richard S. Higgins, Diagonal Mergers, 12 Rev. of Indus. Org. 607 (1997).

[16] See U.S. Federal Trade Commission, FTC Hearing #5: Vertical Merger Analysis and the Role of the Consumer Welfare Standard in U.S. Antitrust Law (Nov. 1, 2018) (providing conference transcripts and presentations), https://www.ftc.gov/news-events/events-calendar/ftc-hearing-5-competition-consumer-protection-21st-century.

[17] See David Hatch, "Diagonal Merger" Enters Antitrust Lexicon, The Deal (Jul. 1, 2020).

[18] U.K. Merger Assessment Guidelines (CC 2 Revised), paras 5.6.1 and 5.6.2.

[19] See D. Gore, S. Lewis, A. Lofaro, & F. Dethmers, The Economic Assessment of Mergers under European Competition Law 502-06 (2013) (describing diagonal mergers and providing examples).

[20] See, e.g., id. (citing Case COMP/M.4731 – Google/DoubleClick (Mar. 11, 2008)).

[21] Vertical Merger Guidelines at 9-10.

[22] Id. at 10.

[23] Id. at 2.

[24] J. Parker & A. Majumdar, UK Merger Control (2016).

[25] Assistant Attorney General Makan Delrahim, "… And Justice for All": Antitrust Enforcement and Digital Gatekeepers (Jun. 11, 2019) (emphasis added), https://www.justice.gov/opa/speech/file/1171341/download.