2023 Draft Merger Guidelines:

A Comment to Add an Anticompetitive Presumption for Exit-Inducing Vertical Arrangements

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1. Introduction

We applaud the meticulous review and modernization of the Merger Guidelines by the Agencies. This document responds to the public inquiry asking for feedback regarding the 2023 Draft Merger Guidelines released on July 19, 2023. Our comment focuses on mergers involving vertical relationships. **Below, in Section 4, we recommend a specific addendum to the Draft Merger Guidelines.** The rest of the document provides context for the addendum.

We suggest adding an anticompetitive presumption regarding vertical arrangements that might induce rivals' exit. These are vertical mergers or mergers involving vertical relationships that might cause the exit of a current market participant. An exit-inducing vertical merger might substantially lessen competition even if, absent exit, it does not.

Thus, rivals' exit can fundamentally alter the evaluation of vertical mergers and mergers involving vertical relationships. The reason is simple. Rivals' exit reduces the number of products available to consumers and the number of competitors that would otherwise exert downward pricing pressure.

We provide a thorough analysis, including a theoretical framework and examples, in a scholarly article attached with this comment, Donna and Pereira (2023a).[1] In this document, we summarize why exit-inducing vertical mergers might offend Section 7 of the Clayton Act[2] and suggest an anticompetitive presumption to incorporate into Merger Guidelines.

2. Exit-Inducing Vertical Mergers: Case Law and Theory of Harm

Distinguishing between lawful and unlawful vertical mergers before they are consummated is no mean feat. Yet a vertical merger that induces rivals' exit might be very harmful, offending Section 7 of the Clayton Act. We argue that rivals' exit should be essential when analyzing vertical mergers. Thus, our proposed addendum in Section 4.

Next, we show that the proposed addendum is backed up by current Supreme Court Opinions, economic theory, and antitrust literature. For details and additional examples, see Donna and Pereira (2023a) and the references therein.[3]

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[1] Donna, Javier D. and P. Pereira (2023a), "Rivals' Exit and Vertical Merger Evaluation," Journal of Competition Law & Economics, Volume 19, Issue 2, pages 220–249, DOI: 10.1093/joclec/nhad002. Preprint is attached with this submission.
[2] 15 U.S.C. § 18.
[3] *Supra* note 1.

2.1. Supreme Court Opinions

In *Brown Shoe Co. v. U.S.* (1962), the Supreme Court's main objection against the vertical merger between Brown and Kinney was that it would likely induce the exit of unintegrated rivals, particularly small, independent shoe manufacturers who supplied Kinney prior to the merger, a Section 7 violation of the Clayton Act:

> "[A] significant aspect of this merger is that it creates a large national chain which is integrated with a manufacturing operation. The retail outlets of integrated companies, by *eliminating wholesalers* and by increasing the volume of purchases from the manufacturing division of the enterprise, can market their own brands at prices below those of competing independent retailers. Of course, some of the results of large integrated or chain operations are beneficial to consumers. Their expansion is not rendered unlawful by the mere fact that *small independent stores may be adversely affected*. It is competition, not competitors, which the Act protects. But we cannot fail to recognize Congress' desire to *promote competition through the protection of viable, small, locally owned businesses.* Congress appreciated that occasional higher costs and prices might result from the maintenance of fragmented industries and markets. It resolved these competing considerations in favor of decentralization. We must give effect to that decision."[4] (Emphasis added.)

FTC v. Procter & Gamble Co. (1967) was a product-extension merger, not a vertical merger. Nevertheless, the same principles apply to the complementary nature of the merger. This feature is reflected in one of the concerns raised by the Supreme Court. Favorably quoting the FTC's "painstaking and illuminating report,"[5] the Supreme Court's Opinion summarized the first anticompetitive concern in the FTC's report by saying that the acquisition may affect the structure of the industry by driving small fringe producers out of the market, which may substantially lessen competition, a Section 7 violation of the Clayton Act:

> "[t]he practical tendency of the ... merger ... is to transform the liquid bleach industry into an arena of big business competition only, with the few small firms that have not disappeared through merger eventually *falling by the wayside*, unable to compete with their giant rivals."[6] (Emphasis added.)

2.2. Theory of Harm

The discussion about the theory of harm in this subsection and the related technical issues that arise can be skipped without loss of continuity.

A horizontal merger increases market power by allowing the internalization of the diversion of sales between firms that produce substitute products. The increase in the merged firms' prices causes a diversion of sales between the substitute products owned by the merged firm, thereby raising the merged firm profit. Rivals benefit from this exercise of market power, as the underlying diversion of sales spills over to their products, which increases their profits. A vertical merger may increase market power—upstream and/or downstream—by allowing the internalization of the diversion of sales between firms that produce complementary products. The increase in the merged firm's prices upstream (downstream) causes a diversion of sales from the rivals' products to the merged firm's products downstream (upstream), thereby decreasing the rivals' profits. The latter might cause some rivals to exit and might substantially lessen competition.

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[4] *Brown Shoe Co. v. U.S.*, 370 U.S. 294 (1962), at 344.
[5] *FTC v. Procter & Gamble Co.,* 386 U.S. 568 (1967), at 570.
[6] *FTC v. Procter & Gamble Co.*, 386 U.S. 568 (1967), at 575.

Both horizontal and vertical mergers might enable marginal cost efficiencies that lower the merged firm's price, diverting sales from rivals and reducing their profits. This issue is potentially more severe for vertical mergers because they might involve the elimination of double marginalization (EDM), subject to the usual caveats.[7] To the extent that it is present, the EDM might have a procompetitive effect. But it also diverts sales from rivals, further increasing their exit probability.

Exit might fundamentally alter the evaluation of a vertical merger. Three relevant effects merit emphasis in this regard. First, exit might reduce product variety, thus hurting consumers. Second, exit might reduce the competitive pressures that active rivals can impose on dominant suppliers. Thus, consumer prices might increase relative to the pre-merger situation. Finally, some forces that arise under vertical integration (those that reduce the prices charged by non-integrated retail rivals) benefit consumers without exit but might hurt them if exit is induced. Therefore, an exit-inducing vertical merger might substantially reduce competition even if it does not offend Section 7 of the Clayton Act absent exit.

The idea that vertical arrangements might induce rivals' exit is not new.[8] Mainstream antitrust and economic scholars have long recognized that vertical integration and vertical schemes may harm horizontal rivals.[9] A vertical merger might induce a rival to exit the market by precluding the rival from covering its operational costs.[10] This concept is embedded in the economic theory of exclusive dealing.[11]

Exit is not required to establish harm in mergers involving vertical arrangements. Nevertheless, if exit occurs, the possibility of harm increases substantially. This perspective provides a unified approach to evaluating horizontal and exit-inducing vertical mergers using similar horizontal-merger standards as the ones in the Draft Merger Guidelines discussed next.

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[7] See Kwoka and Slade (2019), and the references therein, for a recent discussion. Kwoka, John, and Margaret Slade (2019), "Second thoughts on double marginalization," Antitrust 34 (2019): 51.

[8] For a summary, see Donna and Pereira (2023b). Donna, Javier D. and P. Pereira, "Rivals' Exit Should Be Incorporated into the Guidelines for Vertical Merger Evaluation," *ProMarket*, University of Chicago, May 2023, available at: https://www.promarket.org/2023/05/22/rivals-exit-should-be-incorporated-into-the-guidelines-for-vertical-merger-evaluation/

[9] Phillip E. Areeda (late) and Herbert Hovenkamp (2015-2021) [1978], "Antitrust Law: An Analysis of Antitrust Principles and Their Application," ¶1000-¶1041, ¶1600-¶1619, ¶1800-¶1823, Fourth and Fifth Editions; Robert H. Bork (2021) [1978], "The Antitrust Paradox: A Policy at War with Itself," Bork Publishing, ISBN 978-1736089705, at 152-164 and 237-252; Motta, Massimo (2004), "Competition policy: theory and practice," chapter 6, Cambridge University Press; Rey, Patrick and Jean Tirole (2007), "A Primer on Foreclosure," in Handbook of Industrial Organization, Volume 3, edited by Mark Armstrong and Robert H. Porter, 2145-2220, DOI: 10.1016/S1573-448X(06)03033-0; Salop, Steven C., and David T. Scheffman (1983), "Raising Rivals' Costs," American Economic Review, vol. 73:2, 267–71, http://www.jstor.org/stable/1816853.

[10] Either by diverting demand, raising rivals' costs, exclusion, foreclosure, EDM, or other means.

[11] See Eric B . Rasmusen, J. Mark Ramseyer, and John S. Wiley Jr., (1991), "Naked exclusion," American Economic Review, 1137-1145, https://www.jstor.org/stable/2006909; the subsequent comment by Ilya R. Segal and Michael D. Whinston (2000), "Naked Exclusion: Comment," American Economic Review, 90:1, 296-309, DOI: 10.1257/aer.90.1.296; and the extension by Chiara Fumagalli and Massimo Motta (2006), "Exclusive Dealing and Entry, when Buyers Compete," American Economic Review, 96:3, 785-795, DOI: 10.1257/aer.96.3.785. See also Howard P. Marvel, (1982), "Exclusive dealing," Journal of Law and Economics, 25:1, 1-25, DOI: 10.1086/467004; Bernheim, B. Douglas and Michael D. Whinston (1998), "Exclusive dealing," Journal of Political Economy, 106:1, 64-103, DOI: 10.1086/250003; and the references therein. By making it more difficult for a rival to cover its operational costs, a vertical merger may induce a rival out of the market in a similar way as an exclusive contract may make a rival's entry more difficult, thus imposing a negative externality. In the case of an exclusive contract, the incumbent may deter efficient entry; in the case of vertical integration investigated in this Article, the vertically integrated firm may induce rivals' exit. Using data from cement and ready-mixed concrete plants, Hortaçsu and Syverson (2007) empirically study the market power effects of vertical integration on vertical foreclosure, including patterns of prices, productivity, entry, exit, and scale across integrated and unintegrated firms; see Hortaçsu, Ali and Chad Syverson (2007), "Cementing Relationships: Vertical Integration, Foreclosure, Productivity, and Prices," Journal of Political Economy, 115:2, 250-301, DOI: 10.1086/514347. Regarding countervailing buyer power that might keep input prices low, the predictions are sensitive as shown by Alberto Iozzi and Tommaso Valletti (2014), "Vertical bargaining and countervailing power," American Economic Journal: Microeconomics 6:3: 106-35, DOI: 10.1257/mic.6.3.106.

3. Exit Concerns Already Present in the 2023 Draft Merger Guidelines

The Draft Merger Guidelines, released on July 19, 2023, incorporates anticompetitive presumptions/guidelines regarding exit-inducing mergers in several instances. Below is a summary:

> **Guideline 1 (page 6).** "In highly concentrated markets, *a merger that eliminates even a relatively small competitor* creates undue risk that the merger may substantially lessen competition." (Emphasis added.)
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> **Guideline 1 (page 6, footnote 25).** "Similar concerns arise if the merger threatens to *cause the exit of a current market participant,* such as a leveraged buyout that puts the target firm at significant risk of failure." (Emphasis added.)
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> **Guideline 2 (page 8).** "Prior Merger, Entry, and *Exit Events*. The Agencies may look to historical events to assess the presence and substantiality of direct competition between the merging firms. For example, the Agencies may examine the impact of recent relevant mergers, entry, expansion, or *exit events*." (Emphasis added.)
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> **Guideline 2 (page 32).** "Moreover, the entry must be durable: an entrant that does not plan to sustain its investment or *that may exit the market* would not ensure long-term preservation of competition." (Emphasis added.)
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> **Guideline 3 (page 10).** "Aligned Incentives. *Removing a firm* that has different incentives from most others in a market can increase the risk of coordination. For example, a firm with a small market share may have less incentive to coordinate because it has more potential to gain from winning new business than do other firms." (Emphasis added.)
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> **Guideline 3 (page 10).** "*Elimination of a Maverick*. […] A merger that *eliminates a maverick* or significantly changes its incentives increases the susceptibility to coordination." (Emphasis added.)
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> **Guideline 3 (page 10).** "Aligned Incentives. *Removing a firm* that has different incentives from most others in a market can increase the risk of coordination." (Emphasis added.)
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> **Guideline 4 (Section B, page 13 and footnote 45).** "Direct evidence that the firm's presence or behavior has affected or is *affecting current market participants' strategic decisions can also establish a likely influence*.\footnote-45{FTC v. Procter & Gamble, 386 U.S. 568, 581 (1967) (relying on objective evidence that "barriers to entry . . . were not significant" for the acquirer, that the number of potential entrants was "not so large *that the elimination of one would be insignificant*," and that "the acquiring firm was the most likely entrant," in addition to direct evidence of current edge effects on existing competitors' behavior).}" (Emphasis added.)
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> **Guideline 5 (Section A, page 14).** "A merger involving products, services, or customers that rivals use to compete may substantially lessen competition when it results in a firm with both the ability and incentive to make it harder for its rivals to compete in the relevant market, *or to eliminate them* or deter the entry of new firms into the relevant market." (Emphasis added.)
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> **Guideline 7 (page 20).** "*Eliminating a nascent competitive threat*. A nascent threat to a dominant firm is a firm that could grow into a significant rival, facilitate other rivals' growth, or otherwise lead to a reduction in dominance. In assessing a merger that *eliminates a nascent threat*, the Agencies examine the merger's tendency to create a monopoly under Section 7 of the Clayton Act." (Emphasis added.)
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> **Guideline 9 (page 22).** "That trend [toward concentration] can be established by market structure, for example as a steadily increasing HHI exceeds 1,000 and rises toward 1,800. Or it can be

reflected in other market characteristics, such as *the exit of significant players* or other factors driving concentration.” (Emphasis added.)

Rebuttal Evidence (page 32 and footnote 100). “Agencies evaluate *evidence of a failing firm* consistent with this prevailing law.\footnote-100:{The Agencies do not normally credit claims that the assets of a division would *exit the relevant market* in the near future unless: (1) applying cost allocation rules that reflect true economic costs, the division has a persistently negative cash flow on an operating basis, and such negative cash flow is not economically justified for the firm by benefits such as added sales in complementary markets or enhanced customer goodwill; and (2) the owner of the failing division has made unsuccessful good-faith efforts to elicit reasonable alternative offers that would keep its assets in the relevant market and pose a less severe danger to competition than does the proposed acquisition. Because firms can allocate costs, revenues, and intra-company transactions among their subsidiaries and divisions, the Agencies require evidence that is not solely based on management plans that could have been prepared for the purpose of demonstrating negative cash flow or the prospect of *exit from the relevant market.*}.” (Emphasis added.)

Appendix 1 (page 1). “Evidence that the merging parties intend or expect the merger to lessen competition, such as plans to coordinate with other firms, raise prices, reduce output or capacity, reduce product quality or variety, lower wages, cut benefits, *exit a market*, cancel plans to enter a market without a merger, withdraw products or delay their introduction, or curtail research and development efforts after the merger, can be highly informative in evaluating the effects of a merger on competition. The Agencies give little weight, however, to the lack of such evidence or the expressed contrary intent of the merging parties.” (Emphasis added.)

Appendix 2 (Section A, page 3). “Prior Merger, Entry, and *Exit Events*. The Agencies may look to historical events to assess the presence and substantiality of direct competition between the merging firms. For example, the Agencies may examine the impact of recent relevant mergers, entry, expansion, or *exit events*.” (Emphasis added.)

Appendix 3 (Section A.1, page 9). “Benchmark for the SSNIPT. The HMT asks whether the hypothetical monopolist likely would worsen terms relative to those that likely would prevail absent the proposed merger. In some cases, the Agencies will use as a benchmark different outcomes than those prevailing prior to the merger. For example, if outcomes are likely to change absent the merger, e.g., because of innovation, entry, *exit,* or exogenous trends, the Agencies may use anticipated future outcomes as the benchmark.” (Emphasis added.)

The previous presumptions/guidelines correctly identify anticompetitive concerns arising from exit events in mergers that might violate Section 7 of the Clayton Act. **We recommend maintaining them.**

However, an anticompetitive presumption arising **from vertical arrangements is missing** in the current draft. To complement the previous presumptions/guidelines, we recommend the following addendum.

4. Suggested Anticompetitive Presumption for Exit-Inducing Vertical Mergers

We recommend adding an anticompetitive presumption regarding vertical mergers or vertical arrangements that might induce rivals' exit. The anticompetitive presumption might be incorporated into Guideline 6. Below is a specific suggestion:

> **Page 17.** Incorporate the following additional factor into the "Plus Factors Analysis" of Guideline 6, including the suggested footnote:
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> *"**Exit-inducing Vertical Arrangements.** The risk to competition is greater when the vertical merger or vertical arrangement might induce rivals' exit.\footnote{*
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> *Brown Shoe Co. v. U.S., 370 U.S. 294 (1962) at 344: "[A] significant aspect of this merger is that it creates a large national chain which is integrated with a manufacturing operation. The retail outlets of integrated companies, by eliminating wholesalers and by increasing the volume of purchases from the manufacturing division of the enterprise, can market their own brands at prices below those of competing independent retailers. Of course, some of the results of large integrated or chain operations are beneficial to consumers. Their expansion is not rendered unlawful by the mere fact that small independent stores may be adversely affected. It is competition, not competitors, which the Act protects. But we cannot fail to recognize Congress' desire to promote competition through the protection of viable, small, locally owned businesses. Congress appreciated that occasional higher costs and prices might result from the maintenance of fragmented industries and markets. It resolved these competing considerations in favor of decentralization. We must give effect to that decision." Rivals' exit causes horizontal harm, Brown Shoe Co. v. U.S., 370 U.S. 294 (1962) at 345: "Although these mergers have been primarily vertical in their aim and effect, to the extent that they have brought ever greater numbers of retail outlets within fewer and fewer hands, they have had an additional important impact on the horizontal plane." FTC v. Procter & Gamble Co., 386 U.S. 568 (1967), at 575: "[t]he practical tendency of the ... merger ... is to transform the liquid bleach industry into an arena of big business competition only, with the few small firms that have not disappeared through merger eventually falling by the wayside, unable to compete with their giant rivals." "The anticompetitive effects with which this product-extension merger is fraught can easily be seen: [the merger] may substantially reduce the competitive structure of the industry by raising entry barriers and by dissuading the smaller firms from aggressively competing [...]."*
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> }."

The previous suggestion is a straightforward way to incorporate the mentioned anticompetitive presumption into the draft and is our recommendation. Other ways to include the anticompetitive presumption in the Guidelines would be to include it in Guideline 4 or as an additional Guideline.

As indicated in Section 3, the current draft already explains how the Agencies might evaluate exit events and probabilities. The same principles apply to exits induced by vertical mergers and vertical arrangements. Thus, it is not necessary to further elaborate on how the Agencies might evaluate exit events in mergers involving vertical arrangements.

Please do not hesitate to contact us if you have questions.

Sincerely,

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