Emerging Theories of Competitive Harm in Merger Enforcement

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At least since the early 1980s, it has been asserted that "the core principles of merger enforcement policy have remained stable."[1] Horizontal mergers that create, enhance, or facilitate the exercise of market power and vertical transactions that adversely affect horizontal competition are condemned, and consumer welfare is the touchstone by which these assessments are made. That is not to say that merger enforcement policy has been static. New theories of competitive harm and refinements to existing policy have emerged and become codified in judicial precedent or the Merger Guidelines.

In the past few years, the Federal Trade Commission and Department of Justice challenged one merger transaction, and considered challenging another, that departed from the enforcement paradigm of the last thirty years. The first involved a conglomerate transaction, which the courts and agencies have not found objectionable under the Clayton Act in several decades. The second involved a "potential vertical" transaction, which had never before been the subject of antitrust enforcement, to our knowledge.

These cases demonstrate that the antitrust agencies are open to other approaches for analyzing transactions that are believed to present a risk of consumer harm. The cases also suggest that the lack of an existing horizontal or vertical relationship between the merging parties should not necessarily be viewed as an antitrust "green light."

Conglomerate Merger Enforcement: The Lundbeck Case

In August 2005, Lundbeck, Inc. acquired the rights to Indocin IV and several other drugs from Merck.[2] At the time, Indocin was the only pharmacological treatment for patent ductus arteriosus (PDA), a serious heart condition affecting low birth weight babies.[3] For several years prior to the acquisition, Merck had sold a three-vial course of treatment of Indocin for $77.77. Prior to the acquisition, Lundbeck performed a series of market studies and concluded that Indocin was "significantly under priced to the market."[4] After the acquisition, Lundbeck increased the wholesale

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[1] Thomas B. Leary, *The Essential Stability of Merger Policy in the United States*, 70 ANTITRUST L.J. 105, 107 (2002).

[2] Unless otherwise indicated, background information on the *Lundbeck* case is taken from the district court's factual findings, which the FTC did not challenge on appeal. FTC v. Lundbeck, Inc., 2010-2 Trade Cas. (CCH) ¶ 77,160, 2010 U.S. Dist. LEXIS 95365 (D. Minn. Aug. 31, 2010), *aff'd*, 2011-2 Trade Cas. (CCH) ¶ 77,570, 2011 U.S. App. LEXIS 17231 (8th Cir. Aug. 19, 2011). Lundbeck was previously known as Ovation Pharmaceuticals.

[3] Pharmacological treatment is the first-line treatment for PDA for most patients and is much less expensive than surgery. *Id.* ¶¶ 11–12, 2010 U.S. Dist. LEXIS 95365, at *5–6.

[4] *Id.* ¶ 43, 2010 U.S. Dist. LEXIS 95365, at *17. The district court observed that "[c]onsistent with its practice of focusing on its patent-protected drugs, Merck had not changed what was a below-profit-maximizing price of Indocin IV for many years before Lundbeck's acquisition." *Id.* Introduction, 2010 U.S. Dist. LEXIS 95365, at *1–2.

list price of Indocin to $1500 for a three-vial course of treatment.[5] A few months after its acquisition of Indocin, Lundbeck acquired the rights to NeoProfen, the only other drug approved to treat PDA.[6]

In December 2008, the Commission voted unanimously to challenge Lundbeck's acquisition of NeoProfen as a merger to monopoly. Following a bench trial, the District Court for the District of Minnesota denied the FTC's request for relief, finding that the agency had failed to prove that Indocin and NeoProfen were in the same relevant market, and the Eighth Circuit affirmed.[7]

At the time the FTC challenged the NeoProfen transaction, Commissioners Rosch and Leibowitz issued concurring statements indicating that they would have also voted to challenge the acquisition of Indocin, notwithstanding the lack of a horizontal or vertical relationship between Lundbeck and Merck.[8] The Rosch statement explained that there was reason to believe that the acquisition of Indocin violated Section 7 because it eliminated certain reputational constraints specific to Merck, allowing Lundbeck to raise Indocin's price. In particular, the statement noted that Merck had monopoly power over Indocin but did not exercise it because of concerns that increasing prices on a product to treat a vulnerable population could damage the company's reputation and sales of other products. Lundbeck, which lacked a large product portfolio, did not face these constraints and was therefore able to exercise monopoly power after the acquisition.

Reaction to the Rosch statement from the private bar was swift and critical, asserting that it flew in the face of modern economics, was inconsistent with the language of Section 7, and lacked useful limiting principles. Former Commissioner Tom Leary, in contrast, argued that the approach described in the concurring statement was consistent with modern antitrust economics, which "focuses to a large extent on changed management incentives . . . to predict the likelihood that prices will increase post-merger."[9] Merck's reluctance to exploit its pricing power was, in his view, "an economic constraint, pure and simple."[10] He also argued that Merck's right to price at a monopoly level should not immunize Lundbeck's acquisition and subsequent monopoly pricing because Section 7 is concerned with changes resulting from a change in ownership.

Since the *Lundbeck* case, FTC staff has investigated at least one other transaction—also in the pharmaceutical industry—under the principles described in the Rosch statement. In that case, staff concluded that the transaction did not affect the incentives to market the product in a way that would adversely affect consumers and closed that aspect of its investigation.

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5 A few weeks after the acquisition, Lundbeck increased the wholesale list price of Indocin by 40 percent to $108.88 for a three-vial course of treatment. In January 2000, Lundbeck raised Indocin's price again, this time to $1,500 for a three-vial course of treatment. Lundbeck delayed implementation of the full price increase for several months due to concerns that Abbott Laboratories would demand a higher price for the rights to NeoProfen if it learned of Lundbeck's pricing strategy and because of Merck's sensitivity about price increases while Indocin was still being sold under Merck's trade dress. *Id.* ¶¶ 53–58, 2010 U.S. Dist. LEXIS 95365, at *20–22.

6 According to the district court, the NeoProfen acquisition was not the cause of the Indocin price increase. "Lundbeck would have raised the price of Indocin IV to $1500 per three-vial course of treatment even if it had not acquired rights to NeoProfen from Abbott Laboratories." *Id.* ¶ 58, 2010 U.S. Dist. LEXIS 95365, at *22; *see also id.* ¶ 45, 2010 U.S. Dist. LEXIS 95365, at *18 ("After learning of NeoProfen, Lundbeck did not change its plan to increase Indocin IV's price.").

7 *Lundbeck*, 2010 U.S. Dist. LEXIS 95365, *aff'd*, 2011 U.S. App. LEXIS 17231.

8 Concurring Statement of Commissioner J. Thomas Rosch, FTC v. Ovation Pharmaceuticals, Inc., FTC File No. 0810156 (Dec. 16, 2008), *available at* http://www.ftc.gov/os/caselist/0810156/081216ovationroschstmt.pdf; Concurring Statement of Commissioner Jon Leibowitz, FTC v. Ovation Pharmaceuticals, Inc., FTC File No. 0810156 (Dec. 16, 2008), *available at* http://www.ftc.gov/os/caselist/0810156/081216ovationleibowitzstmt.pdf ("I would have supported the approach proposed by Commissioner Rosch.").

9 Thomas B. Leary, *Antitrust Scrutiny of a Pure Conglomerate Merger: The Ovation Case*, ANTITRUST, Summer 2009, at 74, 76.

10 *Id.* at 77.

Implications of Conglomerate Merger Enforcement Under the Lundbeck-Merck Standards

Notwithstanding the criticism that challenging the Indocin acquisition under the standards described in the Rosch statement would lead to an unbounded approach to merger enforcement, the Rosch statement (supported by now-Chairman Leibowitz) identified three important limiting principles to challenging conglomerate transactions.[11]

First, there must be a high degree of confidence in the transaction's competitive effects. That requirement was satisfied in the Lundbeck-Merck transaction, which had closed prior to the FTC's investigation. The agency was able to observe two price increases that occurred shortly after the transaction, leading to an aggregate 1300 percent price increase. The agency also was able to observe that the acquisition resulted in "negative efficiencies": Lundbeck encountered significant manufacturing difficulties with respect to Indocin and within a few years no longer had any of that product to distribute.[12]

The second limiting principle is that the seller must have monopoly power (or near-monopoly power) in a relevant market but not exercise that power. Merck had monopoly power, given that it was the only company to offer a pharmaceutical treatment for PDA. It did not exercise that power due to a reputational constraint.

The third limiting principle is that the transaction must permit the buyer to exercise the seller's monopoly power. In other words, the buyer must not be subject to the same reputational or other constraints as the seller. As noted in the separate statement, it was not enough that Lundbeck had increased prices, but rather that Lundbeck had raised prices to a monopoly level.

The proposed approach to conglomerate merger enforcement described in the Rosch statement permits all of the usual defenses to a facially problematic transaction, including entry and repositioning, efficiencies, and failing firm. The preferred remedy for a violation would be divestiture of the assets to a party that would operate them in a manner similar to the seller. The proposed approach, however, departs from the European model of conglomerate merger enforcement, which focuses on tying and bundling concerns.[13] Rather, the Rosch statement raises a concern analogous to horizontal mergers: the exercise of market power.

If the principles described in the Rosch statement were adopted by the Commission, the added counseling burden on practitioners should be modest. For one thing, it seems unlikely that many markets would satisfy the second limiting principle, which requires not only the possession of monopoly power (or near monopoly power) but also pricing well below the monopoly profit-maximizing level. In addition, the key evidence on which enforcers would rely in unconsummated transactions would be the acquiring company's pre-merger planning documents.[14] Outside counsel should already be reviewing those documents in HSR-reportable transactions as part of the 4c and 4d document collection. Only if the planning documents disclosed an intent to raise

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[11] Rosch Statement, *supra* note 8, at 2–3; *see also Interview with J. Thomas Rosch, Commissioner, Federal Trade Commission*, ANTITRUST, Spring 2009, at 32, 40 (describing limiting principles for challenge to Indocin acquisition).

[12] *Lundbeck*, 2010 U.S. Dist. LEXIS 95365, at *13.

[13] *See* Eur. Comm'n, Guidelines on the Assessment of Non-Horizontal Mergers under the Council Regulation on the Control of Concentrations Between Undertakings (2008), *available at* http://eur-lex.europa.eu/LexUriServ.do?uri=OJ:C:2008:265:0006:0025:EN:PDF.

[14] Likewise, consummated transactions that result in a sizeable price increase (or other action that injures consumers) within a short period of time after closing may warrant scrutiny.

prices substantially (or otherwise take action that will injure consumers) would an unconsummated conglomerate transaction likely warrant scrutiny.[15]

Potential Vertical Mergers: The Google/ITA Case

In April 2011, the DOJ issued a complaint and simultaneously entered into a settlement agreement resolving its concerns with Google Inc.'s acquisition of ITA Software Inc.[16] The DOJ said that the acquisition, as originally proposed, would have substantially lessened competition for comparative flight search websites in the United States, resulting in less innovation and reduced choice for consumers.[17]

According to the DOJ, prior to the acquisition, ITA was the leading provider of airfare pricing and shopping systems (P&S systems), which provide flight information to Internet travel sites, also known as online travel intermediaries (OTI) or comparative flight search services. Internet travel sites are divided into online travel agencies (OTA), which provide flight search and booking services, and so-called metas, which enable consumers to search for flights but do not offer booking services.[18]

The DOJ alleged that P&S systems and comparative flight search services (travel websites) were each relevant product markets. Prior to the transaction, ITA offered a P&S system but not a travel website. Google offered neither a P&S system nor a travel website but planned to develop a travel website in the future, thus making its acquisition a potential vertical transaction.[19] Google had initially sought a license from ITA, but those discussions led to an acquisition after Google determined that it needed a "deep integration" with ITA in order for its new travel website to offer a robust feature set.[20] Google's new product would offer flight search capabilities but not booking, thus falling into the meta category of travel websites.[21]

The DOJ's complaint alleged that the merger would give "Google the means and incentive to use its ownership of [ITA] to foreclose or disadvantage its prospective flight search rivals by degrading access to [ITA's system], or denying them access to [ITA's system] altogether."[22]

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15 A more in-depth review would include confirming the acquiring company's post-merger plans and better understanding the buyer and seller's (very different) competitive strategies.

16 Complaint, United States v. Google Inc., No. 1:11-cv-00688 (D.D.C. Apr. 8, 2011), *available at* http://www.justice.gov/atr/cases/f269600/269618.pdf [hereinafter Google/ITA Complaint]; Competitive Impact Statement, United States v. Google Inc., No. 1:11-cv-00688 (D.D.C. Apr. 8, 2011), *available at* http://www.justice.gov/atr/cases/f269600/269620.pdf [hereinafter Google/ITA Competitive Impact Statement].

17 Unless otherwise indicated, background regarding the Google/ITA case is drawn from the DOJ's complaint and competitive impact statement. *See* Google/ITA Competitive Impact Statement, *supra* note 16, at 2; Google/ITA Complaint, *supra* note 16, ¶¶ 29, 39.

18 OTAs generate revenue primarily through booking fees and to a lesser extent from advertising. Metas generate revenue through advertising sales and referral fees from the airlines and OTAs. *See* Google/ITA Complaint, *supra* note 16, ¶¶ 13–14.

19 The DOJ did not allege that Google was a participant in the comparative flight search services market pre-transaction. While Google's search engine offered some flight search capabilities prior to the transaction, it lacked the functionality of dedicated travel websites. The DOJ also noted that Google had considered developing its own P&S system but declined to proceed given the cost and time involved. *See id.* ¶ 42.

20 Google investor conference call, ITA acquisition agreement signing (July 1, 2010) (statement of Google Executive Chairman Eric Schmidt), *available at* http://investor.google.com/webcast/2010/index.html.

21 Google/ITA Competitive Impact Statement, *supra* note 16, at 9 ("Google intends to launch a new service after completing the transaction that will compete directly with other OTIs by providing flight search results."); Google, *Facts About Google's Acquisition of ITA Software*, http://www.google.com/press/ita/comp.html (2011) ("Google has no plans to sell airline tickets directly to customers, but instead will drive potential customers to airline and online travel agency websites.").

22 Google/ITA Complaint, *supra* note 16, ¶ 5.

According to the complaint, Google would have an incentive to injure other travel websites because the gain in profits from its new travel service would outweigh any lost profits from reduced licensing revenues from the ITA P&S system. The agency also noted a concern about the loss of ITA's "corporate independence,"[23] which had given ITA an incentive to treat its customers on non-discriminatory terms.

Vertical Merger Enforcement Under the Google/ITA Standards

Google/ITA appears to be the first challenge to a potential vertical transaction,[24] yet the complaint and competitive impact statement offer little guidance as to which transactions may be subject to an enforcement action under a potential vertical theory in the future. In particular, the DOJ did not describe the scale, likelihood, or timing of entry by a merging party necessary to trigger concerns. The case does, however, signal a possible expansion of the grounds on which the agency will challenge a vertical merger based on input foreclosure concerns.

The likelihood, timing, and scale of a party's entry are important issues in mergers that raise potential competition concerns. The Agencies have described their views on these issues in the context of horizontal mergers in the 2010 Merger Guidelines,[25] but have not indicated whether the same standards apply to potential vertical transactions. The DOJ, however, did not take the opportunity to address this issue in its Google-ITA court filings, press release, or other public materials discussing its enforcement action. Indeed, those materials describe the transaction as an ordinary vertical merger without highlighting its potential competition aspect.

But even putting aside its potential competition facet, the case also appears to have significant implications for vertical merger enforcement generally. The case indicates a possible expansion of the grounds on which the Antitrust Division will challenge mergers based on an input foreclosure concern.[26] According to the DOJ's own complaint, many—and perhaps most—of the factors that ordinarily signal a risk of foreclosure were not present.

First, both the upstream and downstream markets were not concentrated. The complaint alleged that there were a total of five "significant competitors" in the P&S systems market.[27] The complaint also identified five current competitors in the comparative flight search services market; although, there were undoubtedly many others. Ordinarily, the existence of unconcentrated

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[23] Google/ITA Competitive Impact Statement, *supra* note 16, at 8–9 ("From a competition perspective, ITA's corporate independence from any particular OTI ensures that all of its customers receive the benefits of ITA's cutting edge innovation . . . . This will not be the case once Google purchases ITA.").

[24] *See* 5 PHILLIP W. AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW ¶ 1133b (3d ed. Supp. 2011) ("[N]o case has yet presented the problem of potential vertical relationships.").

[25] U.S. Dep't of Justice & Fed. Trade Comm'n, Horizontal Merger Guidelines §§ 5.1, 5.2, 5.3, 9 (2010); *see also* Darren S. Tucker, *Potential Competition Analysis Under the 2010 Merger Guidelines*, 12 SEDONA CONF. J. 273 (2011).

[26] As the DOJ explained in connection with another recent merger investigation:

> [A] merger may give the vertically integrated entity the ability to establish or protect market power in a downstream market by denying or raising the price of an input to downstream rivals that a stand-alone upstream firm otherwise would sell to those downstream firms. The merged firm may find it profitable to forego the benefits of dealing with its rivals in order to hobble them as competitors to its own downstream operations.

Competitive Impact Statement at 20, United States v. Comcast Corp., No. 1:11-cv-00106 (D.D.C. Jan. 18, 2011), *available at* http://www.justice.gov/atr/cases/f266100/266158.pdf.

[27] Google/ITA Complaint, *supra* note 16, ¶ 24 (identifying ITA, Travelport, Sabre, Amadeus, and Expedia).

upstream and downstream markets would be compelling evidence that foreclosure was unlikely.[28]

Second, the nature of Google's future travel service would give the company a significant incentive not to foreclose other travel websites. Google's new travel service would rely to some extent on other travel websites. This is because Google's travel service lacked a booking function and would drive potential customers to other travel websites (specifically, OTAs) and airline websites. Thus, if Google were to injure other travel websites, it would have also diminished the functionality—and presumably profitability—of its own product.

Third, vertical integration resulting from the Google/ITA transaction appears to have offered the prospect of Google developing a superior travel website. Such a development, even if it had harmed competitors, would have benefited consumers. Given that loss of innovation was one of the DOJ's principal concerns, it would be reasonable to expect that the DOJ's pleadings would have addressed this topic.[29]

Fourth, there were a number of uncertainties regarding Google's yet-to-be-introduced travel website. While it was clear that Google intended to develop a travel website, the timing and nature of Google's entry were not clear (at least based on the public record). These were important considerations. The more time required for Google to enter into the travel website business, for example, the more competitive the other P&S systems were likely to be and the fewer incentives Google would have to foreclose its rivals.[30]

Despite these factors, the Antitrust Division concluded that foreclosure was likely and would be profitable. In reaching this conclusion, the DOJ put significant weight on its finding that ITA was an important and growing competitor in the P&S systems market. The complaint alleged that "[n]o other firm offers a P&S system that is comparable" to the one offered by ITA and that other P&S systems were not "adequate substitutes"—allegations that seemed to suggest that ITA's system was in a relevant market of its own.[31] The DOJ also pointed to ITA's success in winning customer competitions, its technical advantages over its rivals, and its singular focus on its P&S system.

In sum, the DOJ's challenge to Google's acquisition of ITA appears to break new ground in two respects. First, the agency may challenge a transaction when one of the parties is a likely entrant into a market in which the other merger party buys or sells. Second, the agency may conclude that

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28 *See* 4A Areeda & Hovenkamp, *supra* note 24, ¶ 1032a (unless "both markets are highly concentrated," "a vertical merger cannot cause significant foreclosure of existing firms"); Christine A. Varney, Commissioner, Fed. Trade Comm'n, Remarks at the PLI 36th Annual Antitrust Institute, Vertical Merger Enforcement Challenges at the FTC (July 17, 1995), *available at* http://www.ftc.gov/speeches/varney/varta.shtm (in an input foreclosure case, "the greater the market share of the companies that are vertically integrating, the greater the probability that downstream customers will be injured"). *See also* Competitive Impact Statement at 4, United States v. Monsanto Co., No. 1:07-cv-00992 (D.D.C. May 31, 2007), *available at* http://www.usdoj.gov/atr/cases/f223600/223682.pdf (challenging vertical merger where upstream supplier Monsanto had 96% share and downstream supplier DPL had 79% and 87% share of the relevant markets).

If Google cut off access or raised the fees to ITA's service, competing travel websites would have been able to turn to several other P&S systems, which would result in a significant loss of revenue for Google at the upstream level with unclear benefits at the downstream level (because Google's downstream business did not yet exist and its success was uncertain).

29 *Cf.* Comcast Competitive Impact Statement, *supra* note 26, at 29–30 (explaining why vertical integration in video broadcasting industry would not result in efficiencies).

30 Google/ITA Complaint, *supra* note 16, ¶ 37 (alleging that ITA's rivals were improving their systems). In addition, there does not appear to be any claim that the transaction would have foreclosed any upstart competitors or facilitated collusion. *Cf.* Comcast Competitive Impact Statement, *supra* note 26, at 20–27 (challenging vertical transaction that would have impeded nascent, innovative competitors from obtaining an important input); Competitive Impact Statement, United States v. Premdor Inc., No. 1:01CV01696 (D.D.C. Aug. 3, 2001), *available at* http://www.usdoj.gov/atr/cases/f9000/9017.pdf (challenging vertical transaction that would have facilitated collusion through elimination of a disruptive seller).

31 Google/ITA Complaint, *supra* note 16, ¶¶ 27, 41, Header III.D.2.

a vertical or potential vertical transaction presents a risk of input foreclosure if the merging party's upstream product is superior to that of its rivals.[32]

Conclusion

Antitrust counsel are likely to be more comfortable with challenges to potential vertical mergers than to conglomerate mergers. Nevertheless, application of the limiting principles in the Rosch statement should mean that only a fraction of conglomerate transactions would be potentially at risk of being challenged (assuming either agency were to adopt these standards). In contrast, under the Google/ITA standards, it is unclear how many potential vertical transactions are at risk of an enforcement action or what standards the agency will use to evaluate those transactions. In addition, the Google/ITA case seems to indicate that a concentrated market is no longer a prerequisite to input foreclosure concerns in vertical transactions reviewed by the DOJ. Practitioners would undoubtedly benefit from further clarification of the standards under which the DOJ will review these types of transactions.[33]

The Commission has not, to our knowledge, indicated whether it would be willing to challenge a potential vertical transaction and, if it did, what standards it would apply. From our perspective, potential vertical transactions should be subject to the Clayton Act, just as transactions raising potential horizontal competition concerns are. The standards for evaluating potential vertical transactions should be similar to those for ordinary vertical transactions, but take into account the likelihood, timing, and scale of future entry by the merging party that is the potential entrant. Whether the vertical integration is dependent on the transaction is also an important consideration. The 2010 Merger Guidelines, although nominally relevant only to horizontal transactions, may offer some useful guidance as to the treatment of potential competition in a vertical context. Under this approach, challenges to potential vertical mergers should be rare but certainly not nonexistent. ●

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32 Presumably, the same would be true of a superior distributor in a customer foreclosure case.

33 We do not take issue with any of the DOJ's allegations or its decision to seek a remedy but suggest that additional explanation for the agency's decision would have been helpful.