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With Enforcers Locked onto Tech and Antitrust – What Does it Mean for M&A?

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With antitrust enforcement of the technology sector making headlines daily, and as lawmakers focus on strengthening and potentially reforming antitrust laws as a tool to regulate the tech industry, we anticipate a significant increase in scrutiny by US federal antitrust authorities of vertical mergers,[1] including merger of complements and so–called "diagonal mergers" in the technology sector. Notwithstanding the current challenges of vertical merger enforcement,[2] on June 30, 2020, the Federal Trade Commission ("FTC") and the Department of Justice ("DOJ") issued guidelines (the "Vertical Merger Guidelines")[3] describing the practices, techniques and enforcement policies the agencies use to evaluate vertical mergers, and on December 22, 2020, the FTC issued additional guidance on Vertical Merger Enforcement (the "Commentary").[4] Tech companies and dealmakers should be aware of the type of technology related M&A transactions that may potentially be captured under the Vertical Merger Guidelines and Commentary, along with current enforcement priorities at the agencies.

Antitrust Considerations in an M&A Context

Acquirers need to be mindful of the nature of the target's business and evaluate whether it may be in an area currently subject to enhanced antitrust scrutiny. These may include diverse businesses such as platforms, ecommerce, internet infrastructure, social media, search, online advertising, streaming content, and fintech, though new targets are being identified consistently. Parties to transactions (and in particular the acquirer) should consider the following factors:

1. Does the transaction combine businesses that are horizontal competitors (*i.e.* offering directly competing services)?
2. Does the transaction combine businesses that are in a vertical or vendor/vendee relationship (*i.e.* content producer/supplier with content distributor)?
3. Does the transaction combine businesses that are in a diagonal relationship?

a. Horizontal Mergers

To the extent either or both the target and the acquirer are in a business that is presently facing increased antitrust scrutiny, consider whether the acquirer and target businesses are horizontal competitors – *i.e.*, offering directly competing services and would combine firms that may be viewed as head-to-head competitors. In assessing a transaction between horizontal competitors, the regulators will analyze, among other things, the resulting combined market shares, potential for market power or anticompetitive impact and will, to a lesser extent, evaluate potential efficiencies.

The FTC and the DOJ primarily consider whether the transaction will give the combined firm "market power," meaning it has the ability to "raise price, reduce output, diminish innovation, or otherwise harm customers."[5] Market power most commonly manifests as a company's ability to maintain prices above competitive rates for an extended period of time. In their Commentary to the Horizontal Merger Guidance, the regulators note that most mergers between rivals do not inherently create market power.[6] Instead, such mergers more commonly lead to lower prices as the two companies can reduce costs or boost efficiency. However, when a merger will lead to a higher market share for a single company and a highly concentrated market, regulators will scrutinize the probability of competitors acting together—coordinated effects—or the unilateral anticompetitive effects of reducing bargaining across competitors.

Consider the Antitrust Division's recent challenge of the Visa/Plaid merger in 2020.[7] In its challenge, ultimately leading to the parties' decision to abandon the transaction, the DOJ alleged that Visa is a monopolist among providers of online debit services, with a durable market share of approximately 70% and that for the first time in many years, a new type of payments service, pay-by-bank, is poised to take market share away from Visa's online debit business. Plaid, according to the agency's Complaint, was to use "its existing relationships with banks and consumers, to facilitate transactions between consumers and merchants in competition with Visa," and that Visa offered "an unprecedented revenue multiple of over 50X" to thwart head-to-head competition by purchasing Plaid. The Visa/Plaid challenge represents what the agency would call a typical horizontal merger challenge.

b. Vertical Mergers and Merger of Complements

Antitrust law has long recognized that a transaction combining the businesses of an acquirer and a target in a vertical relationship, including combinations of complementary assets such as a critical input to a product, may be similarly anticompetitive. These can include the combination of products used at different levels of the supply chain to make a final product, including for instance content producers or suppliers and content distributors.

We have seen a number of such challenges, and regulators successfully enjoining vertical mergers. As vertical mergers on their face may not immediately reduce existing head-to-head competition, there is often some uncertainty of the anticompetitive impact—especially because vertical mergers require more strained theoretical predictions about the post-merger conduct of the merged entities such as foreclosure.[8] In addition, vertical mergers more often have the effect of realizing efficiencies and reducing costs, which typically benefit customers with lower prices and improved quality products and services. Contrast the perceived harm in a strictly horizontal merger where prices may rise post-transaction, to the perceived harm in a vertical transaction where the access to critical inputs or to distribution channels may be reduced or cut off.

Regulators have focused on vertical mergers that (a) deter or prevent competitors from entering the market,[9] (b) result in anticompetitive foreclosure[10], and (c) reduce access to information[11]. Most recently for example, the FTC has challenged Illumina's proposed acquisition of cancer detection test maker Grail on the grounds that the proposed acquisition would diminish innovation in the U.S. market for certain tests that could be used to detect cancer early, before patients are symptomatic. According to the agency, Illumina is the only viable supplier of a critical input to a class of such tests. Post-merger, Illumina, it is alleged, would have the ability and incentive to "raise prices charged to Grail's competitors [for certain critical inputs], impede Grail competitors' research and development efforts; or refuse or delay executing license agreements [needed] to distribute their tests to third-party laboratories."[12]

c. Diagonal Merger

While antitrust enforcement of *exceptional* vertical mergers that would lead to market foreclosure of inputs or distribution/sales channels has a long history, the trend now is to examine vertical mergers more closely as a matter of course. For example, the Guidelines on Vertical Mergers describe a merger of complements that raises vertical issues and point to the example of a firm manufacturing motors for scooters acquiring the supplier of the batteries required for the scooters.[13] Any scooter manufacturer requires both motors and batteries to create the end product. While the motors and the batteries are not directly vertical to each other in the supply chain, the agency may consider that such a merger would harm both competitors and the customers down-stream who could face discriminatory pricing for failing to purchase both batteries and motors from the combined firm.[14] And, vertical mergers in the tech space can expect to be more likely to raise red flags out of the gate as the agencies work to reign in what some see as outsized influence over the space by a small number of firms.

Such scenarios are fairly common in the tech space where innovative companies often acquire smaller technology companies in a space in which they currently do not have a presence—either to build the technology and combine it with an existing technology or to provide a broader or stronger offering. Labelled “diagonal mergers” in the Vertical Merger Guidelines, these transactions do not involve direct competitors (horizontal) or customers and suppliers (vertical). Instead, these transactions involve businesses in related, but not identical markets who operate at different points in the distribution chain.

The FTC and DOJ provide a scenario in their Vertical Merger Guidelines to describe such a transaction. Consider a business that creates a component that greatly improves the capability of a single function for low-end laptop computers. If a high-end laptop computer manufacturer seeks to acquire such a business, the combination will not improve the acquirer’s product functionality, as the new component belongs in low-end laptops, nor would the acquired technology expand the manufacturer’s product lines.[15] Since the high-end laptop manufacturer is not in the direct supply chain for the component, this is not a true vertical merger. Similarly, the two business do not directly compete with each other for customers horizontally.

However, the regulators raise several concerns to justify subjecting such transactions to antitrust review, such as whether the acquisition will lead to (i) increased laptop prices, (ii) lower quality laptops, or (iii) reduced availability of the new component.[16] The Guidelines specifically note that "the incompatibility between the technologies of the merging firms strongly suggests that this merger is unlikely to generate any benefits." [17] Historically overlooked, antitrust regulators appear poised to intensify investigations into diagonal mergers, particularly with nascent technologies, where businesses seek to acquire complementary technology that increases their prevalence in the market. Consider, for instance, a social media platform acquiring a developer of games that run on a competitor's social media platform. The firms are not head-to-head competitors, nor are they in a vendor/vendee or producer/distributor vertical relationship since the developer's games run only on a competing social media platform. Nonetheless, the acquisition may provide the acquiring social media platform firm with the incentive and ability to harm the competing social media platform by withholding access to the app and distributing it through other channels that do not compete with the acquirer social media platform.

Finally, it is not only acquirers and targets that may run into antitrust scrutiny going forward. While enforcers sometimes view joint ventures as having the effect of restricting competition and subject to additional review and investigation from an antitrust perspective, regulators may be poised to now expand their review to more regularly include investment activities in tech startups and growth companies by large tech companies.

Conclusion

Going forward, we anticipate that regulators will rely on and bring more antitrust cases under vertical and diagonal merger theories in transactions involving tech companies. The bottom line is, in today's antitrust environment, M&A in the tech space warrants a new level of diligence and risk assessment to understand potential pitfalls that may present both before and *after* closing. In addition to the traditional vertical and horizontal transaction structures, companies should be cautious to not ignore transactions that fall outside these two categories as regulators' newfound interest in diagonal mergers could result in heightened scrutiny for historically overlooked transactions.

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[1] As of January 2018, the FTC and DOJ have challenged approximately one vertical merger per year since 2000 (22 in total). *See* D. Bruce Hoffman, Acting Director, Bureau of Competition at Fed. Trade Comm'n, Address at Credit Suisse 2018 Washington Perspectives Conference: Vertical Merger Enforcement at the FTC (Jan. 10, 2018).

[2] *See* United States v. AT&T, Inc., 916 F.3d 1029, 1032 (D.C. Cir. 2019) (observing that under Section 7 of the Clayton Act, the "government must show that the proposed merger is likely to substantially lessen competition, which encompasses a concept of 'reasonable probability,'" and accepting a burden-shifting approach to evaluating such merger challenges).

[3] *See generally* U.S. Dept. of Justice & Fed. Trade Comm'n., Vertical Merger Guidelines (Jun. 30, 2020).

[4] *See* Press Release, Fed. Trade Comm'n., FTC Issues Commentary on Vertical Merger Enforcement (Dec. 22, 2020).

[5] U.S. Dept. of Justice & Fed. Trade Comm'n., Horizontal Merger Guidelines at 2 (Aug. 19, 2010).

[6] U.S. Dept. of Justice & Fed. Trade Comm'n., Commentary on the Horizontal Merger Guidance at 1 (2006).

[7] Complaint, United States v. Visa, No. 20-07810 (N.D. Cal. Nov. 5, 2020).

[8] David Reiffen & Michael Vita, *Is There New Thinking on Vertical Mergers?*, 64 Antitrust L.J. 917, 917-919 (1995).

[9] *See* Hoffman, *supra* note 1, at 4-5 (The FTC will look at whether "assets, know-how, or reputation" in a vertically-related market could make market entry easier for the merging firm as compared to an independent firm.).

[10] *See id.* at 5-6 (The FTC looks at both input foreclosure, favoring a downstream entity of the merged firm or restricting rivals' access to necessary downstream supplies, and customer foreclosure, refusing to purchase inputs from an upstream rival.).

[11] *See id.* at 6-7 (The FTC considers how access to marketing, sales, or margins data of an upstream business could disadvantage the downstream business' rivals.).

[12] Press Release, Fed. Trade Comm'n., FTC Challenges Illumina's Proposed Acquisition of Cancer Detection Test Maker Grail (Mar. 30, 2021).

[13] U.S. Dept. of Justice & Fed. Trade Comm'n., Vertical Merger Guidelines at 9 (Jun. 30, 2020).

[14] *Id*.

[15] *Id*. at 9-10.

[16] *Id*. at 9-10.

[17] *Id*. at 10.

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