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CHAPTER TWO

Insert in place of "Burdens and Orders of Theory and Proof after *California Dental*" at page 230.

The Resulting Order of Proof

The U.S. caselaw appears to adopt the following complex order of proof for assessing when horizontal agreements that could have some theoretically plausible anticompetitive effect violate Sherman Act § 1. In the following, "unrelated" firms means firms that are not in a productive business collaboration whose procompetitive purpose is plausibly alleged to be advanced by the challenged agreement.

Step 1. Does a per se prohibition apply? Is there a horizonal agreement (a) between unrelated market participants (professional or nonprofessional) that *directly* fixes price or output *or* (b) between unrelated *nonprofessional* market participants that divides markets, refuses to deal with particular firms, or indirectly restrains prices or output? If yes, then the agreement is per se illegal, and no procompetitive justifications are admissible, so the plaintiff wins. *See Trenton Potteries; Socony; Maricopa*; *Klor's; Fashion Originators; California Dental.* If no, move to Step 2 to begin rule of reason review. *See BMI; Dagher; NCAA v. Board of Regents; Professional Engineers; Indiana Dentists; California Dental; NCAA v. Alston.*

Step 2. Is the agreement a naked restraint that can be condemned summarily under the abbreviated rule of reason? Have the defendants failed to articulate a theoretically plausible claim that there exists a procompetitive justification for which the restraint was reasonably necessary? If so, then the restraint is "naked" of any procompetitive justification and thus the defendants lose summarily under the abbreviated rule of reason. *See Professional Engineers; Indiana Dentists; California Dental.* If not, move to step 3 to start full-scale rule of reason review. *See BMI; Northwest Stationers; Dagher; California Dental; NCAA v. Alston.*

Step 3. Full-Scale Rule of Reason Review. Under full-scale rule of reason review, there are three stages:

a. Empirically Proving Anticompetitive Effects. The plaintiff first has the burden of producing empirical evidence of anticompetitive effects under the rule of reason. *See California Dental; American Express; NCAA v. Alston.* Such anticompetitive effects can be shown by direct evidence or inferred from market power. *See Indiana Dentists; American Express.* If the plaintiff fails to carry this burden, then the plaintiff loses. If the plaintiff does prove anticompetitive effects, then move to step 3b.

b. *Empirically Proving Procompetitive Effects.* The burden then shifts to the defendants to empirically prove procompetitive effects. If the defendants fail to do so, the defendants lose. *California Dental; NCAA v. Alston.* If the defendants do so, then move to step 3c.

c. *Proving a less anticompetitive alternative.* The burden then shifts to the plaintiff to prove that the procompetitive effects could reasonably have been achieved with a less anticompetitive alternative (i.e., that a "substantially less restrictive alternative" exists). *American Express; NCAA v. Alston.* If the plaintiff does so, the plaintiff wins. If the plaintiff fails to do so, move to step 3d.

d. Balancing. If the case cannot be resolved by the preceding steps, then the factfinder must weigh the anticompetitive and procompetitive effects to determine which is greater. Under the consumer welfare standard, the procompetitive effects must be sufficiently passed on to

consumers so as to outweigh any anticompetitive harm to consumers and result in a net benefit in consumer welfare. The plaintiff has the burden of persuasion on whether the net effect is anticompetitive.

Insert as a primary case at page 290.

NCAA v. Alston,

141 S.Ct. 2141 (2021).

■ Justice GORSUCH delivered the opinion of the Court.

In the Sherman Act, Congress tasked courts with enforcing a policy of competition on the belief that market forces "yield the best allocation" of the Nation's resources. *NCAA v. Univ. of Oklahoma*. The plaintiffs before us brought this lawsuit alleging that the National Collegiate Athletic Association (NCAA) and certain of its member institutions violated this policy by agreeing to restrict the compensation colleges and universities may offer the student-athletes who play for their teams. After amassing a vast record and conducting an exhaustive trial, the district court issued a 50-page opinion that cut both ways. The court refused to disturb the NCAA's rules limiting undergraduate athletic scholarships and other compensation related to athletic performance. At the same time, the court struck down NCAA rules limiting the education-related benefits schools may offer student-athletes—such as rules that prohibit schools from offering graduate or vocational school scholarships. Before us, the student-athletes do not challenge the district court's judgment. But the NCAA does. In essence, it seeks immunity from the normal operation of the antitrust laws and argues, in any event, that the district court should have approved all of its existing restraints. We took this case to consider those objections.

I

A

From the start, American colleges and universities have had a complicated relationship with sports and money. In 1852, students from Harvard and Yale participated in what many regard as the Nation's first intercollegiate competition—a boat race at Lake Winnipesaukee, New Hampshire. But this was no pickup match. A railroad executive sponsored the event to promote train travel to the picturesque lake. He offered the competitors an all-expenses-paid vacation with lavish prizes—along with unlimited alcohol. . . .

[I]t was football that really caused college sports to take off. "By the late 1880s the traditional rivalry between Princeton and Yale was attracting 40,000 spectators and generating in excess of $25,000 . . . in gate revenues." Colleges offered all manner of compensation to talented athletes. Yale reportedly lured a tackle named James Hogan with free meals and tuition, a trip to Cuba, the exclusive right to sell scorecards from his games—and a job as a cigarette agent for the American Tobacco Company. . . .

By 1905, though, a crisis emerged. While college football was hugely popular, it was extremely violent. Plays like the flying wedge and the players' light protective gear led to 7 football fatalities in 1893, 12 deaths the next year, and 18 in 1905. President Theodore Roosevelt responded by convening a meeting between Harvard, Princeton, and Yale to review the rules of the game, a gathering that ultimately led to the creation of what we now know as the NCAA. Organized primarily as a standard-setting body, the association also expressed a view at its founding about compensating college athletes—admonishing that "[n]o student shall represent a College or University in any intercollegiate game or contest who is paid or receives, directly or indirectly, any money, or financial concession."

Reality did not always match aspiration. More than two decades later, the Carnegie Foundation produced a report on college athletics that found them still "sodden with the commercial and the material and the vested interests that these forces have created." . . . Seeking the best players, many schools actively participated in a system "under which boys are offered pecuniary and other inducements to enter a particular college." One coach estimated that a rival team "spent over $200,000 a year on players." . . . In the 1940s, Hugh McElhenny, a halfback at the University of Washington, "became known as the first college player 'ever to take a cut in salary to play pro football.'" He reportedly said: "'[A] wealthy guy puts big bucks under my pillow every time I score a touchdown. Hell, I can't afford to graduate.'"

In 1948, the NCAA sought to do more than admonish. It adopted the "Sanity Code." The code reiterated the NCAA's opposition to "promised pay in any form." But for the first time the code also authorized colleges and universities to pay athletes' tuition. And it created a new enforcement mechanism—providing for the "suspension or expulsion" of "proven offenders." To some, these changes sought to substitute a consistent, above-board compensation system for the varying under-the-table schemes that had long proliferated. To others, the code marked "the beginning of the NCAA behaving as an effective cartel," by enabling its member schools to set and enforce "rules that limit the price they have to pay for their inputs (mainly the 'student-athletes')."

The rules regarding student-athlete compensation have evolved ever since. In 1956, the NCAA expanded the scope of allowable payments to include room, board, books, fees, and "cash for incidental expenses such as laundry." In 1974, the NCAA began permitting paid professionals in one sport to compete on an amateur basis in another. In 2014, the NCAA "announced it would allow athletic conferences to authorize their member schools to increase scholarships up to the full cost of attendance." The 80 member schools of the "Power Five" athletic conferences—the conferences with the highest revenue in Division I—promptly voted to raise their scholarship limits to an amount that is generally several thousand dollars higher than previous limits.

In recent years, changes have continued. The NCAA has created the "Student Assistance Fund" and the "Academic Enhancement Fund" to "assist student-athletes in meeting financial needs," "improve their welfare or academic support," or "recognize academic achievement." These funds have supplied money to student-athletes for "postgraduate scholarships" and "school supplies," as well as "benefits that are not related to education," such as "loss-of-value insurance premiums," "travel expenses," "clothing," and "magazine subscriptions." In 2018, the NCAA made more than $84 million available through the Student Activities Fund and more than $48 million available through the Academic Enhancement Fund. Assistance may be provided in cash or in kind, and there is no limit to the amount any particular student-athlete may receive. Since 2015, disbursements to individual students have sometimes been tens of thousands of dollars above the full cost of attendance.

The NCAA has also allowed payments "'incidental to athletics participation,'" including awards for "participation or achievement in athletics" (like "qualifying for a bowl game") and certain "payments from outside entities" (such as for "performance in the Olympics"). The NCAA permits its member schools to award up to (but no more than) two annual "Senior Scholar Awards" of $10,000 for students to attend graduate school after their athletic eligibility expires. Finally, the NCAA allows schools to fund travel for student-athletes' family members to attend "certain events."

Over the decades, the NCAA has become a sprawling enterprise. Its membership comprises about 1,100 colleges and universities, organized into three divisions. Division I teams are often the most popular and attract the most money and the most talented athletes. Currently, Division I includes roughly 350 schools divided across 32 conferences. Within Division I, the most popular sports are basketball and football. The NCAA divides Division I football into the Football Bowl Subdivision (FBS) and the Football Championship Subdivision, with the FBS generally featuring the best teams. The 32 conferences in Division I function similarly to the NCAA itself, but on a

smaller scale. They "can and do enact their own rules."

At the center of this thicket of associations and rules sits a massive business. The NCAA's current broadcast contract for the March Madness basketball tournament is worth $1.1 billion annually. Its television deal for the FBS conference's College Football Playoff is worth approximately $470 million per year. Beyond these sums, the Division I conferences earn substantial revenue from regular-season games. For example, the Southeastern Conference (SEC) "made more than $409 million in revenues from television contracts alone in 2017, with its total conference revenues exceeding $650 million that year." All these amounts have "increased consistently over the years."

Those who run this enterprise profit in a different way than the student-athletes whose activities they oversee. The president of the NCAA earns nearly $4 million per year. Commissioners of the top conferences take home between $2 to $5 million. College athletic directors average more than $1 million annually. And annual salaries for top Division I college football coaches approach $11 million, with some of their assistants making more than $2.5 million.

B

The plaintiffs are current and former student-athletes in men's Division I FBS football and men's and women's Division I basketball. They filed a class action against the NCAA and 11 Division I conferences (for simplicity's sake, we refer to the defendants collectively as the NCAA). The student-athletes challenged the "current, interconnected set of NCAA rules that limit the compensation they may receive in exchange for their athletic services." Specifically, they alleged that the NCAA's rules violate § 1 of the Sherman Act . . . .

After pretrial proceedings stretching years, the district court conducted a 10-day bench trial. . . . The NCAA did not "contest evidence showing" that it and its members have agreed to compensation limits on student-athletes; the NCAA and its conferences enforce these limits by punishing violations; and these limits "affect interstate commerce." . . .

In applying the rule of reason, the district court began by observing that the NCAA enjoys "near complete dominance of, and exercise[s] monopsony power in, the relevant market"—which it defined as the market for "athletic services in men's and women's Division I basketball and FBS football, wherein each class member participates in his or her sport-specific market." The "most talented athletes are concentrated" in the "markets for Division I basketball and FBS football." There are no "viable substitutes," as the "NCAA's Division I essentially *is* the relevant market for elite college football and basketball." In short, the NCAA and its member schools have the "power to restrain student-athlete compensation in any way and at any time they wish, without any meaningful risk of diminishing their market dominance."

The district court then proceeded to find that the NCAA's compensation limits "produce significant anticompetitive effects in the relevant market." Though member schools compete fiercely in recruiting student-athletes, the NCAA uses its monopsony power to "cap artificially the compensation offered to recruits." In a market without the challenged restraints, the district court found, "competition among schools would increase in terms of the compensation they would offer to recruits, and student-athlete compensation would be higher as a result." "Student-athletes would receive offers that would more closely match the value of their athletic services." And notably, the court observed, the NCAA "did not meaningfully dispute" any of this evidence.

The district court next considered the NCAA's procompetitive justifications for its restraints. The NCAA suggested that its restrictions help increase output in college sports and maintain a competitive balance among teams. But the district court rejected those justifications, and the NCAA does not pursue them here. The NCAA's only remaining defense was that its rules preserve amateurism, which in turn widens consumer choice by providing a unique product—amateur college sports as distinct from professional sports. Admittedly, this asserted benefit accrues to

consumers in the NCAA's seller-side consumer market rather than to student-athletes whose compensation the NCAA fixes in its buyer-side labor market. But, the NCAA argued, the district court needed to assess its restraints in the labor market in light of their procompetitive benefits in the consumer market—and the district court agreed to do so.

Turning to that task, the court observed that the NCAA's conception of amateurism has changed steadily over the years. The court noted that the NCAA "nowhere define[s] the nature of the amateurism they claim consumers insist upon." And, given all this, the court struggled to ascertain for itself "any coherent definition" of the term, noting the testimony of a former SEC commissioner that he's "'never been clear on ... what is really meant by amateurism.'"

Nor did the district court find much evidence to support the NCAA's contention that its compensation restrictions play a role in consumer demand. As the court put it, the evidence failed "to establish that the challenged compensation rules, in and of themselves, have any direct connection to consumer demand." The court observed, for example, that the NCAA's "only economics expert on the issue of consumer demand" did not "study any standard measures of consumer demand" but instead simply "interviewed people connected with the NCAA and its schools, who were chosen for him by defense counsel." Meanwhile, the student-athletes presented expert testimony and other evidence showing that consumer demand has increased markedly despite the new types of compensation the NCAA has allowed in recent decades. The plaintiffs presented economic and other evidence suggesting as well that further increases in student-athlete compensation would "not negatively affect consumer demand." At the same time, however, the district court did find that one particular aspect of the NCAA's compensation limits "may have some effect in preserving consumer demand." Specifically, the court found that rules aimed at ensuring "student-athletes do not receive unlimited payments unrelated to education" could play some role in product differentiation with professional sports and thus help sustain consumer demand for college athletics.

The court next required the student-athletes to show that "substantially less restrictive alternative rules" existed that "would achieve the same procompetitive effect as the challenged set of rules." The district court emphasized that the NCAA must have "ample latitude" to run its enterprise and that courts "may not use antitrust laws to make marginal adjustments to broadly reasonable market restraints." In light of these standards, the court found the student-athletes had met their burden in some respects but not others. The court rejected the student-athletes' challenge to NCAA rules that limit athletic scholarships to the full cost of attendance and that restrict compensation and benefits unrelated to education. These may be price-fixing agreements, but the court found them to be reasonable in light of the possibility that "professional-level cash payments ... could blur the distinction between college sports and professional sports and thereby negatively affect consumer demand."

The court reached a different conclusion for caps on education-related benefits—such as rules that limit scholarships for graduate or vocational school, payments for academic tutoring, or paid posteligibility internships. On no account, the court found, could such education-related benefits be "confused with a professional athlete's salary." If anything, they "emphasize that the recipients are students." Enjoining the NCAA's restrictions on these forms of compensation alone, the court concluded, would be substantially less restrictive than the NCAA's current rules and yet fully capable of preserving consumer demand for college sports.

The court then entered an injunction reflecting its findings and conclusions. Nothing in the order precluded the NCAA from continuing to fix compensation and benefits unrelated to education; limits on athletic scholarships, for example, remained untouched. The court enjoined the NCAA only from limiting education-related compensation or benefits that conferences and schools may provide to student-athletes playing Division I football and basketball. The court's injunction further specified that the NCAA could continue to limit cash awards for academic achievement—but only so long as those limits are no lower than the cash awards allowed for

athletic achievement (currently $5,980 annually). The court added that the NCAA and its members were free to propose a definition of compensation or benefits "'related to education.'" And the court explained that the NCAA was free to regulate how conferences and schools provide education-related compensation and benefits. The court further emphasized that its injunction applied only to the NCAA and multi-conference agreements—thus allowing individual conferences (and the schools that constitute them) to impose tighter restrictions if they wish. The district court's injunction issued in March 2019, and took effect in August 2020.

Both sides appealed. … In the end, the court of appeals affirmed in full, explaining its view that "the district court struck the right balance in crafting a remedy that both prevents anticompetitive harm to Student-Athletes while serving the procompetitive purpose of preserving the popularity of college sports."

C

Unsatisfied with this result, the NCAA asks us to reverse to the extent the lower courts sided with the student-athletes. For their part, the student-athletes do not renew their across-the-board challenge to the NCAA's compensation restrictions. Accordingly, we do not pass on the rules that remain in place or the district court's judgment upholding them. Our review is confined to those restrictions now enjoined.

Before us, as through much of the litigation below, some of the issues most frequently debated in antitrust litigation are uncontested. The parties do not challenge the district court's definition of the relevant market. They do not contest that the NCAA enjoys monopoly (or, as it's called on the buyer side, monopsony) control in that labor market—such that it is capable of depressing wages below competitive levels and restricting the quantity of student-athlete labor. Nor does the NCAA dispute that its member schools compete fiercely for student-athletes but remain subject to NCAA-issued-and-enforced limits on what compensation they can offer. Put simply, this suit involves admitted horizontal price fixing in a market where the defendants exercise monopoly control.

Other significant matters are taken as given here too. No one disputes that the NCAA's restrictions *in fact* decrease the compensation that student-athletes receive compared to what a competitive market would yield. No one questions either that decreases in compensation also depress participation by student-athletes in the relevant labor market—so that price and quantity are both suppressed. Nor does the NCAA suggest that, to prevail, the plaintiff student-athletes must show that its restraints harm competition in the seller-side (or consumer facing) market as well as in its buyer-side (or labor) market.

Meanwhile, the student-athletes do not question that the NCAA may permissibly seek to justify its restraints in the labor market by pointing to procompetitive effects they produce in the consumer market. Some *amici* argue that "competition in input markets is incommensurable with competition in output markets," and that a court should not "trade off" sacrificing a legally cognizable interest in competition in one market to better promote competition in a different one; review should instead be limited to the particular market in which antitrust plaintiffs have asserted their injury. But the parties before us do not pursue this line.

II

A

With all these matters taken as given, we express no views on them. Instead, we focus only on the objections the NCAA *does* raise. Principally, it suggests that the lower courts erred by subjecting its compensation restrictions to a rule of reason analysis. In the NCAA's view, the courts should have given its restrictions at most an "abbreviated deferential review," before approving them.

The NCAA offers a few reasons why. Perhaps dominantly, it argues that it is a joint venture

and that collaboration among its members is necessary if they are to offer consumers the benefit of intercollegiate athletic competition. We doubt little of this. There's no question, for example, that many "joint ventures are calculated to enable firms to do something more cheaply or better than they did it before." And the fact that joint ventures can have such procompetitive benefits surely stands as a caution against condemning their arrangements too reflexively. See *Dagher*, 547 U.S. at 7; *BMI*.

But even assuming (without deciding) that the NCAA is a joint venture, that does not guarantee the foreshortened review it seeks. Most restraints challenged under the Sherman Act—including most joint venture restrictions—are subject to the rule of reason, which (again) we have described as "a fact-specific assessment of market power and market structure" aimed at assessing the challenged restraint's "actual effect on competition"—especially its capacity to reduce output and increase price. *American Express*.

Admittedly, the amount of work needed to conduct a fair assessment of these questions can vary. As the NCAA observes, this Court has suggested that sometimes we can determine the competitive effects of a challenged restraint in the "'twinkling of an eye.'" *NCAA v. Board of Regents; American Needle*. That is true, though, only for restraints at opposite ends of the competitive spectrum. For those sorts of restraints—rather than restraints in the great in-between—a quick look is sufficient for approval or condemnation.

At one end of the spectrum, some restraints may be so obviously incapable of harming competition that they require little scrutiny. In *Rothery Storage & Van Co. v. Atlas Van Lines, Inc.*, 792 F.2d 210 (CADC 1986), for example, Judge Bork explained that the analysis could begin and end with the observation that the joint venture under review "command[ed] between 5.1 and 6% of the relevant market." Usually, joint ventures enjoying such small market share are incapable of impairing competition. Should they reduce their output, "there would be no effect upon market price because firms making up the other 94% of the market would simply take over the abandoned business."

At the other end, some agreements among competitors so obviously threaten to reduce output and raise prices that they might be condemned as unlawful *per se* or rejected after only a quick look. See *Dagher*, 547 U.S. at 7, n. 3; *California Dental*. Recognizing the inherent limits on a court's ability to master an entire industry—and aware that there are often hard-to-see efficiencies attendant to complex business arrangements—we take special care not to deploy these condemnatory tools until we have amassed "considerable experience with the type of restraint at issue" and "can predict with confidence that it would be invalidated in all or almost all instances." *Leegin*.

None of this helps the NCAA. The NCAA *accepts* that its members collectively enjoy monopsony power in the market for student-athlete services, such that its restraints can (and in fact do) harm competition. Unlike customers who would look elsewhere when a small van company raises its prices above market levels, the district court found (and the NCAA does not here contest) that student-athletes have nowhere else to sell their labor. Even if the NCAA is a joint venture, then, it is hardly of the sort that would warrant quick-look approval for all its myriad rules and restrictions.

Nor does the NCAA's status as a particular type of venture categorically exempt its restraints from ordinary rule of reason review. We do not doubt that some degree of coordination between competitors within sports leagues can be procompetitive. Without some agreement among rivals—on things like how many players may be on the field or the time allotted for play—the very competitions that consumers value would not be possible. See *NCAA v. Board of Regents*. Accordingly, even a sports league with market power might see some agreements among its members win antitrust approval in the "'twinkling of an eye.'" *American Needle*.

But this insight does not always apply. That *some* restraints are necessary to create or

maintain a league sport does not mean *all* "aspects of elaborate interleague cooperation are." *American Needle.* While a quick look will often be enough to approve the restraints "necessary to produce a game," *American Needle.* a fuller review may be appropriate for others. See, *e.g., Chicago Professional Sports Ltd. Partnership v. NBA*, 95 F.3d 593, 600 (CA7 1996) ("Just as the ability of McDonald's franchises to coordinate the release of a new hamburger does not imply their ability to agree on wages for counter workers, so the ability of sports teams to agree on a TV contract need not imply an ability to set wages for players").

The NCAA's rules fixing wages for student-athletes fall on the far side of this line. Nobody questions that Division I basketball and FBS football can proceed (and have proceeded) without the education-related compensation restrictions the district court enjoined; the games go on. Instead, the parties dispute whether and to what extent those restrictions in the NCAA's labor market yield benefits in its consumer market that can be attained using substantially less restrictive means. That dispute presents complex questions requiring more than a blink to answer.

B

Even if background antitrust principles counsel in favor of the rule of reason, the NCAA replies that a particular precedent ties our hands. The NCAA directs our attention to *NCAA v. Board of Regents*, where this Court considered the league's rules restricting the ability of its member schools to televise football games. On the NCAA's reading, that decision expressly approved its limits on student-athlete compensation—and this approval forecloses any meaningful review of those limits today.

We see things differently. *NCAA v. Board of Regents* explained that the league's television rules amounted to "[h]orizontal price fixing and output limitation[s]" of the sort that are "ordinarily condemned" as "'illegal *per se*.'" The Court declined to declare the NCAA's restraints *per se* unlawful only because they arose in "an industry" in which some "horizontal restraints on competition are essential if the product is to be available at all." Our analysis today is fully consistent with all of this. Indeed, if any daylight exists it is only in the NCAA's favor. While *NCAA v. Board of Regents* did not condemn the NCAA's broadcasting restraints as *per se* unlawful, it invoked abbreviated antitrust review as a path to condemnation, not salvation. If a quick look was thought sufficient before rejecting the NCAA's procompetitive rationales in that case, it is hard to see how the NCAA might object to a court providing a more cautious form of review before reaching a similar judgment here.

To be sure, the NCAA isn't without a reply. It notes that, in the course of reaching its judgment about television marketing restrictions, the *NCAA v. Board of Regents* Court commented on student-athlete compensation restrictions. Most particularly, the NCAA highlights this passage:

> "The NCAA plays a critical role in the maintenance of a revered tradition of amateurism in college sports. There can be no question but that it needs ample latitude to play that role, or that the preservation of the student-athlete in higher education adds richness and diversity to intercollegiate athletics and is entirely consistent with the goals of the Sherman Act." *Id.*

See also *id.* (the NCAA "seeks to market a particular brand of football" in which "athletes must not be paid, must be required to attend class, and the like"). On the NCAA's telling, these observations foreclose any rule of reason review in this suit.

Once more, we cannot agree. *NCAA v. Board of Regents* may suggest that courts should take care when assessing the NCAA's restraints on student-athlete compensation, sensitive to their procompetitive possibilities. But these remarks do not suggest that courts must reflexively reject *all* challenges to the NCAA's compensation restrictions. Student-athlete compensation rules were not even at issue in *NCAA v. Board of Regents*. And the Court made clear it was only assuming

the reasonableness of the NCAA's restrictions: "It is reasonable to *assume* that most of the regulatory controls of the NCAA are justifiable means of fostering competition among amateur athletic teams and are therefore procompetitive ...." *Id.* Accordingly, the Court simply did not have occasion to declare—nor did it declare—the NCAA's compensation restrictions procompetitive both in 1984 and forevermore.

Our confidence on this score is fortified by still another factor. Whether an antitrust violation exists necessarily depends on a careful analysis of market realities. See, *e.g., American Express.* If those market realities change, so may the legal analysis.

When it comes to college sports, there can be little doubt that the market realities have changed significantly since 1984. Since then, the NCAA has dramatically increased the amounts and kinds of benefits schools may provide to student-athletes. For example, it has allowed the conferences flexibility to set new and higher limits on athletic scholarships. It has increased the size of permissible benefits "incidental to athletics participation." And it has developed the Student Assistance Fund and the Academic Enhancement Fund, which in 2018 alone provided over $100 million to student-athletes. Nor is that all that has changed. In 1985, Division I football and basketball raised approximately $922 million and $41 million respectively. By 2016, NCAA Division I schools raised more than $13.5 billion. From 1982 to 1984, CBS paid $16 million per year to televise the March Madness Division I men's basketball tournament. In 2016, those annual television rights brought in closer to $1.1 billion.

Given the sensitivity of antitrust analysis to market realities—and how much has changed in this market—we think it would be particularly unwise to treat an aside in *NCAA v. Board of Regents* as more than that. This Court may be "infallible only because we are final," *Brown* v. *Allen*, 344 U. S. 443, 540 (1953) (Jackson, J., concurring in result), but those sorts of stray comments are neither.

C

The NCAA submits that a rule of reason analysis is inappropriate for still another reason—because the NCAA and its member schools are not "commercial enterprises" and instead oversee intercollegiate athletics "as an integral part of the undergraduate experience." The NCAA represents that it seeks to "maintain amateurism in college sports as part of serving [the] societally important non-commercial objective" of "higher education."

Here again, however, there may be less of a dispute than meets the eye. The NCAA does not contest that its restraints affect interstate trade and commerce and are thus subject to the Sherman Act. The NCAA acknowledges that this Court already analyzed (and struck down) some of its restraints as anticompetitive in *NCAA v. Board of Regents*. And it admits, as it must, that the Court did all this only after observing that the Sherman Act had already been applied to other nonprofit organizations—and that "the economic significance of the NCAA's nonprofit character is questionable at best" given that "the NCAA and its member institutions are in fact organized to maximize revenues." *Id.* Nor, on the other side of the equation, does anyone contest that the status of the NCAA's members as schools and the status of student-athletes as students may be relevant in assessing consumer demand as part of a rule of reason review.

With this much agreed it is unclear exactly what the NCAA seeks. To the extent it means to propose a sort of judicially ordained immunity from the terms of the Sherman Act for its restraints of trade—that we should overlook its restrictions because they happen to fall at the intersection of higher education, sports, and money—we cannot agree. This Court has regularly refused materially identical requests from litigants seeking special dispensation from the Sherman Act on the ground that their restraints of trade serve uniquely important social objectives beyond enhancing competition.

Take two examples. In *Professional Engineers,* a trade association argued that price competition between engineers competing for building projects had to be restrained to ensure

quality work and protect public safety. This Court rejected that appeal as "nothing less than a frontal assault on the basic policy of the Sherman Act." *Id.* The "statutory policy" of the Act is one of competition and it "precludes inquiry into the question whether competition is good or bad." *Id.* In *Trial Lawyers,* criminal defense lawyers agreed among themselves to refuse court appointments until the government increased their compensation. And once more the Court refused to consider whether this restraint of trade served some social good more important than competition: "The social justifications proffered for respondents' restraint of trade ... do not make it any less unlawful." *Id.*

To be sure, this Court once dallied with something that looks a bit like an antitrust exemption for professional baseball. In *Federal Baseball Club v. National League*, 259 U.S. 200 (1922), the Court reasoned that "exhibitions" of "base ball" did not implicate the Sherman Act because they did not involve interstate trade or commerce—even though teams regularly crossed state lines (as they do today) to make money and enhance their commercial success. But this Court has refused to extend *Federal Baseball*'s reasoning to other sports leagues—and has even acknowledged criticisms of the decision as "'unrealistic'" and "'inconsistent'" and "aberration[al]." *Flood v. Kuhn*, 407 U.S. 258, 282 (1972). Indeed, as we have seen, this Court has already recognized that the NCAA itself *is* subject to the Sherman Act.

The "orderly way" to temper that Act's policy of competition is "by legislation and not by court decision." *Id.* The NCAA is free to argue that, "because of the special characteristics of [its] particular industry," it should be exempt from the usual operation of the antitrust laws—but that appeal is "properly addressed to Congress." *Professional Engineers*. Nor has Congress been insensitive to such requests. It has modified the antitrust laws for certain industries in the past, and it may do so again in the future. See, *e.g.*, 7 U.S.C. §§ 291–292 (agricultural cooperatives); 15 U.S.C. §§ 1011–1013 (insurance); 15 U.S.C. §§ 1801–1804 (newspaper joint operating agreements). But until Congress says otherwise, the only law it has asked us to enforce is the Sherman Act, and that law is predicated on one assumption alone—"competition is the best method of allocating resources" in the Nation's economy. *Professional Engineers.*

III

A

While the NCAA devotes most of its energy to resisting the rule of reason in its usual form, the league lodges some objections to the district court's application of it as well.

When describing the rule of reason, this Court has sometimes spoken of "a three-step, burden-shifting framework" as a means for "'distinguish[ing] between restraints with anticompetitive effect that are harmful to the consumer and restraints stimulating competition that are in the consumer's best interest.'" *American Express*. As we have described it, "the plaintiff has the initial burden to prove that the challenged restraint has a substantial anticompetitive effect." *Id.* Should the plaintiff carry that burden, the burden then "shifts to the defendant to show a procompetitive rationale for the restraint." *Id.* If the defendant can make that showing, "the burden shifts back to the plaintiff to demonstrate that the procompetitive efficiencies could be reasonably achieved through less anticompetitive means." *Id.*

These three steps do not represent a rote checklist, nor may they be employed as an inflexible substitute for careful analysis. As we have seen, what is required to assess whether a challenged restraint harms competition can vary depending on the circumstances. The whole point of the rule of reason is to furnish "an enquiry meet for the case, looking to the circumstances, details, and logic of a restraint" to ensure that it unduly harms competition before a court declares it unlawful. *California Dental;* see also, *e.g., Leegin* ("'[T]he factfinder weighs all of the circumstances of a case in deciding whether a restrictive practice should be prohibited as imposing an unreasonable restraint on competition'"); *Copperweld*.

In the proceedings below, the district court followed circuit precedent to apply a multistep

framework closely akin to *American Express*'s. As its first step, the district court required the student-athletes to show that "the challenged restraints produce significant anticompetitive effects in the relevant market." This was no slight burden. According to sone *amicus*, courts have disposed of nearly all rule of reason cases in the last 45 years on the ground that the plaintiff failed to show a substantial anticompetitive effect. Brief for 65 Professors of Law, Business, Economics, and Sports Management as *Amici Curiae* 21, n. 9 ("Since 1977, courts decided 90% (809 of 897) on this ground"). This suit proved different. As we have seen, based on a voluminous record, the district court held that the student-athletes had shown the NCAA enjoys the power to set wages in the market for student-athletes' labor—and that the NCAA has exercised that power in ways that have produced significant anticompetitive effects. Perhaps even more notably, the NCAA "did not meaningfully dispute" this conclusion.

Unlike so many cases, then, the district court proceeded to the second step, asking whether the NCAA could muster a procompetitive rationale for its restraints. This is where the NCAA claims error first crept in. On its account, the district court examined the challenged rules at different levels of generality. At the first step of its inquiry, the court asked whether the NCAA's entire package of compensation restrictions has substantial anticompetitive effects *collectively*. Yet, at the second step, the NCAA says the district court required it to show that each of its distinct rules limiting student-athlete compensation has procompetitive benefits *individually*. The NCAA says this mismatch had the result of effectively—and erroneously—requiring it to prove that each rule is the least restrictive means of achieving the procompetitive purpose of differentiating college sports and preserving demand for them.

We agree with the NCAA's premise that antitrust law does not require businesses to use anything like the least restrictive means of achieving legitimate business purposes. To the contrary, courts should not second-guess "degrees of reasonable necessity" so that "the lawfulness of conduct turn[s] upon judgments of degrees of efficiency." *Rothery Storage*, 792 F.2d at 227; *GTE Sylvania*. That would be a recipe for disaster, for a "skilled lawyer" will "have little difficulty imagining possible less restrictive alternatives to most joint arrangements." 11 Areeda & Hovenkamp ¶1913b, p. 398 (2018). And judicial acceptance of such imaginings would risk interfering "with the legitimate objectives at issue" without "adding that much to competition." 7 *id.*, ¶1505b, at 435–436.

Even worse, "[r]ules that seek to embody every economic complexity and qualification may well, through the vagaries of administration, prove counter-productive, undercutting the very economic ends they seek to serve." *Barry Wright Corp. v. ITT Grinnell Corp.*, 724 F.2d 227, 234 (CA1 1983) (BREYER, J.). After all, even "[u]nder the best of circumstances," applying the antitrust laws "'can be difficult'"—and mistaken condemnations of legitimate business arrangements "'are especially costly, because they chill the very'" procompetitive conduct "'the antitrust laws are designed to protect.'" *Trinko*. Indeed, static judicial decrees in ever-evolving markets may themselves facilitate collusion or frustrate entry and competition. *Ibid.* To know that the Sherman Act prohibits only *unreasonable* restraints of trade is thus to know that attempts to "'[m]ete[r]' small deviations is not an appropriate antitrust function." Hovenkamp, Antitrust Balancing, 12 N. Y. U. J. L. & Bus. 369, 377 (2016).

While we agree with the NCAA's legal premise, we cannot say the same for its factual one. Yes, at the first step of its inquiry, the district court held that the student-athletes had met their burden of showing the NCAA's restraints collectively bear an anticompetitive effect. And, given that, yes, at step two the NCAA had to show only that those same rules collectively yield a procompetitive benefit. The trouble for the NCAA, though, is not the level of generality. It is the fact that the district court found unpersuasive much of its proffered evidence. Recall that the court found the NCAA failed "to establish that the challenged compensation rules ... have any direct connection to consumer demand."

To be sure, there is a wrinkle here. While finding the NCAA had failed to establish that its

rules collectively sustain consumer demand, the court did find that "some" of those rules "may" have procompetitive effects "to the extent" they prohibit compensation "unrelated to education, akin to salaries seen in professional sports leagues." The court then proceeded to what corresponds to the third step of the *American Express* framework, where it required the student-athletes "to show that there are substantially less restrictive alternative rules that would achieve the same procompetitive effect as the challenged set of rules." And there, of course, the district court held that the student-athletes partially succeeded—they were able to show that the NCAA could achieve the procompetitive benefits it had established with substantially less restrictive restraints on education-related benefits.

Even acknowledging this wrinkle, we see nothing about the district court's analysis that offends the legal principles the NCAA invokes. The court's judgment ultimately turned on the key question at the third step: whether the student-athletes could prove that "substantially less restrictive alternative rules" existed to achieve the same procompetitive benefits the NCAA had proven at the second step. Of course, deficiencies in the NCAA's proof of procompetitive benefits at the second step influenced the analysis at the third. But that is only because, however framed and at whichever step, anticompetitive restraints of trade may wind up flunking the rule of reason to the extent the evidence shows that substantially less restrictive means exist to achieve any proven procompetitive benefits. See, *e.g.,* 7 Areeda & Hovenkamp ¶1505, p. 428 ("To be sure, these two questions can be collapsed into one," since a "legitimate objective that is not promoted by the challenged restraint can be equally served by simply abandoning the restraint, which is surely a less restrictive alternative").

Simply put, the district court nowhere—expressly or effectively—required the NCAA to show that its rules constituted the *least* restrictive means of preserving consumer demand. Rather, it was only after finding the NCAA's restraints "'patently and inexplicably stricter than is necessary'" to achieve the procompetitive benefits the league had demonstrated that the district court proceeded to declare a violation of the Sherman Act. That demanding standard hardly presages a future filled with judicial micromanagement of legitimate business decisions.

B

In a related critique, the NCAA contends the district court "impermissibly redefined" its "product" by rejecting its views about what amateurism requires and replacing them with its preferred conception.

This argument, however, misapprehends the way a defendant's procompetitive business justification relates to the antitrust laws. Firms deserve substantial latitude to fashion agreements that serve legitimate business interests—agreements that may include efforts aimed at introducing a new product into the marketplace. But none of that means a party can relabel a restraint as a product feature and declare it "immune from § 1 scrutiny." *American Needle*. In this suit, as in any, the district court had to determine whether the defendants' agreements harmed competition and whether any procompetitive benefits associated with their restraints could be achieved by "substantially less restrictive alternative" means.

The NCAA's argument not only misapprehends the inquiry, it would require us to overturn the district court's factual findings. While the NCAA asks us to defer to its conception of amateurism, the district court found that the NCAA had not adopted any consistent definition. Instead, the court found, the NCAA's rules and restrictions on compensation have shifted markedly over time. The court found, too, that the NCAA adopted these restrictions without any reference to "considerations of consumer demand," and that some were "not necessary to preserve consumer demand." None of this is product redesign; it is a straightforward application of the rule of reason.

C

Finally, the NCAA attacks as "indefensible" the lower courts' holding that substantially less

restrictive alternatives exist capable of delivering the same procompetitive benefits as its current rules. The NCAA claims, too, that the district court's injunction threatens to "micromanage" its business.

Once more, we broadly agree with the legal principles the NCAA invokes. As we have discussed, antitrust courts must give wide berth to business judgments before finding liability. Similar considerations apply when it comes to the remedy. Judges must be sensitive to the possibility that the "continuing supervision of a highly detailed decree" could wind up impairing rather than enhancing competition. *Trinko*. Costs associated with ensuring compliance with judicial decrees may exceed efficiencies gained; the decrees themselves may unintentionally suppress procompetitive innovation and even facilitate collusion. Judges must be wary, too, of the temptation to specify "the proper price, quantity, and other terms of dealing"—cognizant that they are neither economic nor industry experts. *Trinko*. Judges must be open to reconsideration and modification of decrees in light of changing market realities, for "what we see may vary over time." *California Dental*. And throughout courts must have a healthy respect for the practical limits of judicial administration: "An antitrust court is unlikely to be an effective day-to-day enforcer" of a detailed decree, able to keep pace with changing market dynamics alongside a busy docket. *Trinko*. Nor should any court "'impose a duty ... that it cannot explain or adequately and reasonably supervise.'" *Ibid.* In short, judges make for poor "central planners" and should never aspire to the role. *Id.*

Once again, though, we think the district court honored these principles. The court enjoined only restraints on education-related benefits—such as those limiting scholarships for graduate school, payments for tutoring, and the like. The court did so, moreover, only after finding that relaxing these restrictions would not blur the distinction between college and professional sports and thus impair demand—and only after finding that this course represented a significantly (not marginally) less restrictive means of achieving the same procompetitive benefits as the NCAA's current rules.

Even with respect to education-related benefits, the district court extended the NCAA considerable leeway. As we have seen, the court provided that the NCAA could develop its own definition of benefits that relate to education and seek modification of the court's injunction to reflect that definition. The court explained that the NCAA and its members could agree on rules regulating how conferences and schools go about providing these education-related benefits. The court said that the NCAA and its members could continue fixing education-related cash awards, too—so long as those "limits are never lower than the limit" on awards for athletic performance. And the court emphasized that its injunction applies only to the NCAA and multiconference agreements; individual conferences remain free to reimpose every single enjoined restraint tomorrow—or more restrictive ones still.

In the end, it turns out that the NCAA's complaints really boil down to three principal objections.

First, the NCAA worries about the district court's inclusion of paid posteligibility internships among the education-related benefits it approved. The NCAA fears that schools will use internships as a way of circumventing limits on payments that student-athletes may receive for athletic performance. The NCAA even imagines that boosters might promise posteligibility internships "at a sneaker company or auto dealership" with extravagant salaries as a "thinly disguised vehicle" for paying professional-level salaries.

This argument rests on an overly broad reading of the injunction. The district court enjoined only restrictions on education-related compensation or benefits "that may be made available *from conferences or schools*." Accordingly, as the student-athletes concede, the injunction "does not stop the NCAA from continuing to prohibit compensation from" sneaker companies, auto dealerships, boosters, "or anyone else." The NCAA itself seems to understand this much. Following the district court's injunction, the organization adopted new regulations specifying that only "a conference or

institution" may fund post-eligibility internships.

Even when it comes to internships offered by conferences and schools, the district court left the NCAA considerable flexibility. The court refused to enjoin NCAA rules prohibiting its members from providing compensation or benefits unrelated to legitimate educational activities—thus leaving the league room to police phony internships. As we've observed, the district court also allowed the NCAA to propose (and enforce) rules defining what benefits do and do not relate to education. Accordingly, the NCAA may seek whatever limits on paid internships it thinks appropriate. And, again, the court stressed that individual conferences may restrict internships however they wish. All these features underscore the modesty of the current decree.

Second, the NCAA attacks the district court's ruling that it may fix the aggregate limit on awards schools may give for "academic or graduation" achievement no lower than its aggregate limit on parallel athletic awards (currently $5,980 per year). This, the NCAA asserts, "is the very definition of a professional salary." Brief for Petitioner in No. 20–512, at 48. The NCAA also represents that "[m]ost" of its currently permissible athletic awards are "for genuine individual or team *achievement*" and that "[m]ost ... are received by only a few student-athletes each year." *Ibid.* Meanwhile, the NCAA says, the district court's decree would allow a school to pay players thousands of dollars each year for minimal achievements like maintaining a passing GPA. *Ibid.*

The basis for this critique is unclear. The NCAA does not believe that the athletic awards it presently allows are tantamount to a professional salary. And this portion of the injunction sprang directly from the district court's finding that the cap on athletic participation awards "is an amount that has been shown not to decrease consumer demand." Indeed, there was no evidence before the district court suggesting that corresponding academic awards would impair consumer interest in any way. Again, too, the district court's injunction affords the NCAA leeway. It leaves the NCAA free to reduce its athletic awards. And it does not ordain what criteria schools must use for their academic and graduation awards. So, once more, if the NCAA believes certain criteria are needed to ensure that academic awards are legitimately related to education, it is presently free to propose such rules—and individual conferences may adopt even stricter ones.

Third, the NCAA contends that allowing schools to provide in-kind educational benefits will pose a problem. This relief focuses on allowing schools to offer scholarships for "graduate degrees" or "vocational school" and to pay for things like "computers" and "tutoring." But the NCAA fears schools might exploit this authority to give student-athletes "'luxury cars'" "to get to class" and "other unnecessary or inordinately valuable items" only "nominally" related to education.

Again, however, this over-reads the injunction in ways we have seen and need not belabor. Under the current decree, the NCAA is free to forbid in-kind benefits unrelated to a student's actual education; nothing stops it from enforcing a "no Lamborghini" rule. And, again, the district court invited the NCAA to specify and later enforce rules delineating which benefits it considers legitimately related to education. To the extent the NCAA believes meaningful ambiguity really exists about the scope of its authority—regarding internships, academic awards, in-kind benefits, or anything else—it has been free to seek clarification from the district court since the court issued its injunction three years ago. The NCAA remains free to do so today. To date, the NCAA has sought clarification only once—about the precise amount at which it can cap academic awards—and the question was quickly resolved. Before conjuring hypothetical concerns in this Court, we believe it best for the NCAA to present any practically important question it has in district court first.

When it comes to fashioning an antitrust remedy, we acknowledge that caution is key. Judges must resist the temptation to require that enterprises employ the least restrictive means of achieving their legitimate business objectives. Judges must be mindful, too, of their limitations—as generalists, as lawyers, and as outsiders trying to understand intricate business relationships. Judges must remain aware that markets are often more effective than the heavy hand of judicial power when it comes to enhancing consumer welfare. And judges must be open to clarifying and

reconsidering their decrees in light of changing market realities. Courts reviewing complex business arrangements should, in other words, be wary about invitations to "set sail on a sea of doubt." *Addyston Pipe*. But we do not believe the district court fell prey to that temptation. Its judgment does not float on a sea of doubt but stands on firm ground—an exhaustive factual record, a thoughtful legal analysis consistent with established antitrust principles, and a healthy dose of judicial humility.

*

Some will think the district court did not go far enough. By permitting colleges and universities to offer enhanced education-related benefits, its decision may encourage scholastic achievement and allow student-athletes a measure of compensation more consistent with the value they bring to their schools. Still, some will see this as a poor substitute for fuller relief. At the same time, others will think the district court went too far by undervaluing the social benefits associated with amateur athletics. For our part, though, we can only agree with the Ninth Circuit: "'The national debate about amateurism in college sports is important. But our task as appellate judges is not to resolve it. Nor could we. Our task is simply to review the district court judgment through the appropriate lens of antitrust law.'" That review persuades us the district court acted within the law's bounds.

The judgment is *Affirmed.*

■ Justice KAVANAUGH, concurring**.**

The NCAA has long restricted the compensation and benefits that student athletes may receive. And with surprising success, the NCAA has long shielded its compensation rules from ordinary antitrust scrutiny. Today, however, the Court holds that the NCAA has violated the antitrust laws. The Court's decision marks an important and overdue course correction, and I join the Court's excellent opinion in full.

But this case involves only a narrow subset of the NCAA's compensation rules—namely, the rules restricting the *education-related* benefits that student athletes may receive, such as post-eligibility scholarships at graduate or vocational schools. The rest of the NCAA's compensation rules are not at issue here and therefore remain on the books. Those remaining compensation rules generally restrict student athletes from receiving compensation or benefits from their colleges for playing sports. And those rules have also historically restricted student athletes from receiving money from endorsement deals and the like.

I add this concurring opinion to underscore that the NCAA's remaining compensation rules also raise serious questions under the antitrust laws. Three points warrant emphasis.

First, the Court does not address the legality of the NCAA's remaining compensation rules. As the Court says, "the student-athletes do not renew their across-the-board challenge to the NCAA's compensation restrictions. Accordingly, we do not pass on the rules that remain in place or the district court's judgment upholding them. Our review is confined to those restrictions now enjoined."

Second, although the Court does not weigh in on the ultimate legality of the NCAA's remaining compensation rules, the Court's decision establishes how any such rules should be analyzed going forward. After today's decision, the NCAA's remaining compensation rules should receive ordinary "rule of reason" scrutiny under the antitrust laws. The Court makes clear that the decades-old "stray comments" about college sports and amateurism made in *NCAA v. Board of Regents* were dicta and have no bearing on whether the NCAA's current compensation rules are lawful. And the Court stresses that the NCAA is not otherwise entitled to an exemption from the antitrust laws. As a result, absent legislation or a negotiated agreement between the NCAA and the student athletes, the NCAA's remaining compensation rules should be subject to ordinary rule of reason scrutiny.

Third, there are serious questions whether the NCAA's remaining compensation rules can pass muster under ordinary rule of reason scrutiny. Under the rule of reason, the NCAA must supply a legally valid procompetitive justification for its remaining compensation rules. As I see it, however, the NCAA may lack such a justification.

The NCAA acknowledges that it controls the market for college athletes. The NCAA concedes that its compensation rules set the price of student athlete labor at a below-market rate. And the NCAA recognizes that student athletes currently have no meaningful ability to negotiate with the NCAA over the compensation rules.

The NCAA nonetheless asserts that its compensation rules are procompetitive because those rules help define the product of college sports. Specifically, the NCAA says that colleges may decline to pay student athletes because the defining feature of college sports, according to the NCAA, is that the student athletes are not paid.

In my view, that argument is circular and unpersuasive. The NCAA couches its arguments for not paying student athletes in innocuous labels. But the labels cannot disguise the reality: The NCAA's business model would be flatly illegal in almost any other industry in America. All of the restaurants in a region cannot come together to cut cooks' wages on the theory that "customers prefer" to eat food from low-paid cooks. Law firms cannot conspire to cabin lawyers' salaries in the name of providing legal services out of a "love of the law." Hospitals cannot agree to cap nurses' income in order to create a "purer" form of helping the sick. News organizations cannot join forces to curtail pay to reporters to preserve a "tradition" of public-minded journalism. Movie studios cannot collude to slash benefits to camera crews to kindle a "spirit of amateurism" in Hollywood.

Price-fixing labor is price-fixing labor. And price-fixing labor is ordinarily a textbook antitrust problem because it extinguishes the free market in which individuals can otherwise obtain fair compensation for their work. See, *e.g.*, *Texaco Inc. v. Dagher*, 547 U.S. 1, 5 (2006). Businesses like the NCAA cannot avoid the consequences of price-fixing labor by incorporating price-fixed labor into the definition of the product. Or to put it in more doctrinal terms, a monopsony cannot launder its price-fixing of labor by calling it product definition.

The bottom line is that the NCAA and its member colleges are suppressing the pay of student athletes who collectively generate *billions* of dollars in revenues for colleges every year. Those enormous sums of money flow to seemingly everyone except the student athletes. College presidents, athletic directors, coaches, conference commissioners, and NCAA executives take in six- and seven-figure salaries. Colleges build lavish new facilities. But the student athletes who generate the revenues, many of whom are African American and from lower-income backgrounds, end up with little or nothing.

Everyone agrees that the NCAA can require student athletes to be enrolled students in good standing. But the NCAA's business model of using unpaid student athletes to generate billions of dollars in revenue for the colleges raises serious questions under the antitrust laws. In particular, it is highly questionable whether the NCAA and its member colleges can justify not paying student athletes a fair share of the revenues on the circular theory that the defining characteristic of college sports is that the colleges do not pay student athletes. And if that asserted justification is unavailing, it is not clear how the NCAA can legally defend its remaining compensation rules.

If it turns out that some or all of the NCAA's remaining compensation rules violate the antitrust laws, some difficult policy and practical questions would undoubtedly ensue. Among them: How would paying greater compensation to student athletes affect non-revenue-raising sports? Could student athletes in some sports but not others receive compensation? How would any compensation regime comply with Title IX? If paying student athletes requires something like a salary cap in some sports in order to preserve competitive balance, how would that cap be administered? And given that there are now about 180,000 Division I student athletes, what is a

financially sustainable way of fairly compensating some or all of those student athletes?

Of course, those difficult questions could be resolved in ways other than litigation. Legislation would be one option. Or colleges and student athletes could potentially engage in collective bargaining (or seek some other negotiated agreement) to provide student athletes a fairer share of the revenues that they generate for their colleges, akin to how professional football and basketball players have negotiated for a share of league revenues. Cf. *Brown v. Pro Football, Inc.*, 518 U.S. 231, 235–237 (1996); *Wood v. National Basketball Assn.*, 809 F.2d 954, 958–963 (CA2 1987) (R. Winter, J.). Regardless of how those issues ultimately would be resolved, however, the NCAA's current compensation regime raises serious questions under the antitrust laws.

To be sure, the NCAA and its member colleges maintain important traditions that have become part of the fabric of America—game days in Tuscaloosa and South Bend; the packed gyms in Storrs and Durham; the women's and men's lacrosse championships on Memorial Day weekend; track and field meets in Eugene; the spring softball and baseball World Series in Oklahoma City and Omaha; the list goes on. But those traditions alone cannot justify the NCAA's decision to build a massive money-raising enterprise on the backs of student athletes who are not fairly compensated. Nowhere else in America can businesses get away with agreeing not to pay their workers a fair market rate on the theory that their product is defined by not paying their workers a fair market rate. And under ordinary principles of antitrust law, it is not evident why college sports should be any different. The NCAA is not above the law.

NOTES AND QUESTIONS ON *NCAA V. ALSTON*[1]

1. Why wasn't the NCAA agreement to cap compensation to players per se illegal as a buyer cartel? The challenged restraint was a horizontal agreement to fix the prices paid for labor, so it was literally a buyer cartel. How then did the *NCAA* avoid per se illegality? The answer is that, as also discussed in *NCAA v. Board of Regents,* the NCAA members were involved in the unique productive business collaboration of putting on sporting contests, and the NCAA was deemed to have plausibly alleged that the restraint was ancillary to that collaboration. In short, for buyer price-fixing, the per se rule does not apply to restraints that are ancillary to productive business collaborations, just as is the case for the per se rules regarding horizontal agreements on seller price-fixing, *see BMI,* output restraints, *see NCAA v. Board of Regents,* and concerted refusals to deal, *see Associated Press; Northwest Stationers.*

2. What was the claimed procompetitive justification? The NCAA claimed that what made college sports attractive to consumers in a way that distinguished it from professional sports was that college players were amateurs. (In the lower court, the NCAA had also claimed that restricting player compensation increased output and helped maintain competitive balance, but the NCAA abandoned those claims before the Supreme Court.) The restraints on player compensation were thus claimed to be necessary to make the product commercially attractive to consumers. This creates the seeming irony that the NCAA was justifying protecting the player market from commercialism in order to make its downstream product more commercially attractive, but that was what was necessary to frame the argument as a procompetitive justification. *See NCAA v. Board of Regents; Professional Engineers; Indiana Dentists.*

3. Is it theoretically plausible that restraining college player compensation could preserve amateurism in a way that increases consumer demand for college sports? The answer appears to be "yes", because culturally much of the attraction of college sports has been attributed to the fact that it is played by student-athletes. Perhaps because of this, the popularity

[1] Disclosure: Professor Elhauge was one of many amici professors who, pro bono, filed a brief in support of the players before the Supreme Court in this case.

of college football and basketball relative to professional NFL football and NBA basketball seems much higher than professional AAA baseball's popularity relative to professional Major League Baseball. On the other hand, what drives the distinctive consumer demand for college sports might not be the fact that the players are unpaid amateurs, but rather the facts that the athletes are students and/or that the teams play for colleges that consumers like rooting for or against for other reasons. Further, college baseball seems even less popular with consumers than professional AAA baseball is. Thus, although the justification seems theoretically plausible, there remain the empirical questions of whether the justification is factually true, of how large any such procompetitive effects on product value might be, and on what precise types and levels of compensation limits any such procompetitive effects might turn.

4. Is fixing low prices for labor because consumers prefer a product made with low-priced labor something that should not count as procompetitive in principle? Even if we assume that restraining the compensation of student-athletes does increase consumer demand for college sports, does that effect count in principle as procompetitive when this satisfaction of consumer preferences is achieved by restraining free market competition for upstream labor? The district court treated it as so, but at least Justice Kavanaugh seemed skeptical. He concluded that the NCAA's claimed procompetitive justification was "unpersuasive", reasoning that its business model of fixing a low input price for labor because consumers preferred a product made by low-priced labor "would be flatly illegal in almost any other industry in America," including, for example, restaurants, law firms, hospitals, news organizations, and movie studios. He did not seem to mean that these analogies made the NCAA claim *empirically* unpersuasive, given that one could well image the empirics differing between college sports and these other industries as to the plausibility of a consumer preference for products made by low-paid labor. He instead seemed to mean that, even if the claim were empirically true in these other industries, the claimed justification should be deemed *legally* unpersuasive because on principle it is not procompetitive to anticompetitively fix labor prices to cater to a consumer preference for products made with low-priced labor. Such a conclusion would make the NCCA restraints on compensation a naked restraint, unclothed by any legitimate procompetitive justification, and thus illegal under the abbreviated rule of reason without the need for any empirical inquiry.

The argument that anticompetitive effects in an input market could not be justified based on procompetitive effects in a downstream output market was also made by some amici. The Supreme Court did not address the issue, however, because before the Supreme Court "the student-athletes do not question that the NCAA may permissibly seek to justify its restraints in the labor market by pointing to procompetitive effects they produce in the consumer market." However, this and other language in the Supreme Court's opinion suggested that it might well have been sympathetic to the argument had the student-athletes raised it before the high court.

If this issue is raised in the future, how should it be resolved? If the framing of the procompetitive justification effectively admits that the restraint anticompetitively harms sellers in the input market, then the principle that anticompetitive effects in one market cannot be justified based on procompetitive effects in another market could cut against this being a cognizable procompetitive justification. But some might argue that this principle does not apply when the defendants are a productive joint venture that uses such a restraint to makes their product more attractive in a way that benefits downstream consumers, because, under the consumer welfare standard, the latter trumps. This is one of the controversial issues currently being debated about the meaning and desirability of the consumer welfare standard.

A stronger version of the procompetitive justification would exist if it were plausible that the restraint on input market competition might increase consumer demand so much that it produces a net benefit to input suppliers. Suppose, for example, it were the case that without compensation

limits, all consumer demand for college sports would evaporate, so that colleges would cease all sports funding and not even offer athletic scholarships anymore. If so, then the compensation limits would make the student-athletes better off because with the limits they would receive athletic scholarships, whereas without them they would receive nothing. In such a case, the principle of trading off harms in one market against benefits in another market would no longer govern, because both market levels would benefit from the restraint, and thus it seems unlikely that the courts would conclude such a justification was inadmissible on principle. On the other hand, such a stronger claim might not be plausible, especially given the historical evidence, and certainly would be harder to prove empirically.

5. Were anticompetitive effects proven? Yes, because the NCAA did not contest that it had monopsony power in the labor market for college athletes and that it restrained and lowered compensation for those athletes. Indeed, the NCAA could hardly have contested those conclusions because its procompetitive justification that its restraints were necessary to preserve amateurism *depended* on its restraints preventing price competition for college athletes from increasing their compensation.

6. Was a procompetitive effect on product value empirically proven? As the Supreme Court noted, the district court found that the NCAA provided no economic evidence that its compensation limits increased consumer demand for college sports, whereas the plaintiffs provided contrary economic evidence that consumer demand for college sports had increased despite various NCAA rule changes that increased the types and levels of compensation allowed to student athletes. Moreover, the district court found that the NCAA had adopted and modified its compensation limits over time without doing any analysis of their effect on consumer demand. Further, the history recounted by the Supreme Court indicated that for nearly 100 years, from 1852 to 1948, college sports grew and flourished during an era where there was rampant compensation to student athletes because it had not yet been restrained by the NCAA. This history suggests that amateurism and compensation limits were not necessary to make college sports attractive. To be sure, one could argue that the popularity of professional sports has grown since 1948 in a way that makes it more important now to differentiate college sports from their professional counterparts. But while that might provide grounds to distinguish the historical evidence, it does not help with the fact that recent economic evidence provided no empirical support for the NCAA's claim that its compensation restraints preserved a form of amateurism that increased consumer demand for college sports.

Why then did the NCAA not lose on the simple grounds that it failed to provide empirical evidence that its posited procompetitive effect existed in reality? Mainly because the district court concluded that there was testimony that maintaining some differentiation between college and professional supports was important to consumer demand and that it "may" be true that this differentiation would be undermined if totally unlimited payments to college athletes led to them being paid professional-level salaries. Thus, although the NCAA failed to provide empirical evidence to support the assertion that its actual types and levels of compensation limits increased consumer demand for college sports, the district court assumed that preventing totally unlimited payments did have the procompetitive effect of maintaining a differentiation from professional sports that preserved consumer demand for college sports. This assumption was something of a leap, given that it lacked affirmative empirical support and that it ignored other evidence that what gave college sports their distinctive consumer demand was not the fact that players were unpaid, but rather the fact that the athletes were students and that consumers like rooting for or against certain colleges. 375 F. Supp. 3d at 1079, 1082.

Before the Supreme Court, the plaintiffs did not challenge any rulings that were unfavorable to it, so the Supreme Court had no occasion to consider whether the district court's finding of

procompetitive effects had sufficient empirical support. But much of the unanimous Supreme Court opinion, and even more of the Kavanaugh concurrence, suggests that, unless the NCAA can come up with stronger empirical evidence that preserving amateurism is important to preserve demand for college sports, its restrictions on compensating student athletes are likely to be stricken in their entirety.

7. Did the student-athletes prove that a substantially less restrictive alternative existed? At trial, the student-athletes had offered three less restrictive alternatives. The district found that the first two alternatives would allow unlimited payments to student athletes, and thus would fail to advance the procompetitive justification of preventing unlimited payments to student-athletes that "could" undermine the distinction between college and professional sports. 375 F. Supp. 3d at 1086-87. The third alternative was maintaining the NCAA's caps on *non-educational* compensation (i.e., rules that limit athletic scholarships to the full cost of attendance and restrict compensation and benefits unrelated to education), while eliminating the NCAA's caps on *education-related* benefits (i.e., the rules that limited payments for things like academic tutoring, internships, and scholarships for graduate or vocational school). The district court held this was a substantially less restrictive alternative that was fully capable of preserving consumer demand for college sports because such education-related benefits both emphasized the student nature of the recipient and could not be confused with professional-like salaries. Because the student-athletes did not, at the Supreme Court, challenge rulings adverse to them, the Supreme Court had no occasion to address the legality of the NCAA's caps on non-educational compensation. Instead, the Supreme Court considered only the NCCA's challenge to the invalidation of its caps on education-related benefits.

8. Why were the NCCA's arguments before the Supreme Court rejected? As to the invalidation of the NCAA cap on education-related benefits, the NCAA raised five arguments. ***First,*** the NCAA argued that because its restraint was ancillary to a productive business collaboration, only abbreviated deferential review should apply. The Supreme Court rejected this argument because, under cases like *BMI,* being ancillary to a productive business collaboration just gets a horizontal restraint out of per se illegality and into the rule of reason. To be sure, the rule of reason could sometimes sustain a restraint with abbreviated review if the collaboration's market share was too small to make anticompetitive effects plausible (as in *Rothery*) or if the product could not be offered at all without the relevant agreement (such as NCAA rules on how college sporting contests are played), but even the NCAA acknowledged that it had monopsony power and that college sporting contests could proceed (and had proceeded) without restricting player compensation.

Second, the NCAA argued that meaningful review of the challenged restraints was precluded by language in *NCAA v. Board of Regents,* which stated that the NCAA played a critical role in maintaining amateurism in college sports. But in that case the Court merely assumed for the sake of argument that such amateurism made college sports more attractive to TV viewers, rejecting that theoretical argument on the grounds that there clearly existed a substantially less anticompetitive alternative for advancing that goal than the restraint on the output of televised college games at issue in that case, namely the alternative of increasing enforcement of college compensation limits of the sort at issue in this case. As the Supreme Court indicated, this holding that the procompetitive justification was sufficiently theoretically plausible to be considered hardly constituted empirical evidence that the justification was factually true in 1984, when *NCAA v. Board of Regents* was decided, and certainly could not constitute empirical evidence that it was factually true in 2021, when this case was decided.

Third, the NCCA argued that rule of reason analysis was inappropriate because the NCCA and its members were not commercial enterprises and were seeking to protect amateurism to

advance non-commercial objectives of higher education. But the NCAA acknowledged that its restraints affected commerce (and thus were covered by the Sherman Act even though the NCAA and its members were nonprofits) and that some NCAA restraints had been stricken in *NCAA v. Board of Regents*. Further, many cases like *Professional Engineers* and *Trial Lawyers* have held that anticompetitive restraints could not be defended based on the justification that restraining competition better advanced social welfare.

Fourth, the NCAA argued that the district court's review excessively micromanaged the NCAA by requiring that each of its restraint be the very least restrictive alternative for advancing its claimed procompetitive justifications. The Supreme Court agreed that such micromanaging would be improper, but it concluded that in fact the district court had instead properly found that the NCAA's restraints collectively had substantially less restrictive alternatives.

Fifth, the NCAA argued that the district court improperly redefined the NCAA's product by rejecting the NCAA's views about what amateurism required. The Supreme Court rejected this argument on principle because it effectively claimed that defendants could immunize themselves from judicial review of whether their restraints had procompetitive effects by simply labeling those restraints as part of their definition of the product. The Kavanaugh concurrence likewise rejected this argument as "circular." Indeed, the NCAA's argument resembles the rejected argument in *NCAA v. Board of Regents* that its output restraints should avoid scrutiny because they created the "new product" of "exclusive TV rights" that were more valuable to advertisers. If defining a product as an output-limited product that increased advertiser demand did not escape rule of reason review, likewise defining the product as a product produced by price-fixed labor that increased consumer demand would not escape rule of reason review either.

The Supreme Court also rejected this argument on the facts because the NCAA had no consistent definition of amateurism and over time had repeatedly changed the compensation limits that it claimed amateurism required. Further, the changes in definition were adopted without any NCAA consideration of the effect on consumer demand, the ostensible procompetitive justification.

9. Why might the district court have agreed to allow different NCAA conferences to set their own compensation limits? Although the NCAA collectively clearly had monopoly power in the labor market for college athletes, individual conferences would have much less market power. Thus, if individual conferences truly set compensation limits independently of each other, they would have incentives to compete by offering higher compensation to attract student-athletes away from other conferences. Further, while individual conferences might justifiably want to cap compensation to players to increase parity among teams that play each other, in order to make the games closer and thus more entertaining for consumers, this is a much stronger argument for conferences (whose teams play each other) than for the NCAA as whole (whose teams mainly do not). Thus, if individual conferences truly set their compensation limits independently of each other, it is far more likely that those limits would have procompetitive effects that could offset any anticompetitive effects.

10. Which, if any, of the NCAA's remaining limits on non-educational compensation will survive antitrust scrutiny in the future? An earlier Ninth Circuit decision had involved NCAA rules that prevented student-athletes from being paid for licenses to use their names, images, and likenesses in videogames and telecasts. *O'Bannon v. NCAA,* 802 F.3d 1049 (9th Cir. 2015). The Ninth Circuit allowed these rules to the extent that they prevented players from being paid more than their cost of attending college, but not otherwise. After the Supreme Court decision, does it seem likely that any of these rules will be sustained? One might think it unlikely that allowing student-athletes to be paid for the right to use their names and images in videogames and telecasts would ever really suffice to undermine the differentiation of college

sports from professional sports in a way that lessens consumer demand for college sports. One might think it is particularly unlikely that they would undermine differentiation when the license agreement or payments occur after student graduation.

What about the other limitations on paid compensation? The Supreme Court (especially Justice Kavanaugh) seemed skeptical that restraining labor prices to increase consumer demand counted as procompetitive even on principle, as well as skeptical that the empirical evidence showed that prohibiting pay to student-athletes increased consumer demand for college sports. Further, even if limiting pay to student-athletes were justifiably necessary to differentiate college sports from professional sports, one might think that a substantially less restrictive alternative would be to cap pay to student-athletes at some level that could be quite substantial without being so high that anyone would confuse them with professional-level salaries, though that would raise the difficult question of defining just what that level was. Do you think any of the NCAA's current limits on athlete compensation will survive in the future and, of so, which and to what extent?

CHAPTER THREE

Insert as a primary case after note 4 at page 382.

Ohio v. American Express Co.

138 S.Ct. 2274 (2018).

■ Justice THOMAS delivered the opinion of the Court.

American Express Company and American Express Travel Related Services Company (collectively, Amex) provide credit-card services to both merchants and cardholders. When a cardholder buys something from a merchant who accepts Amex credit cards, Amex processes the transaction through its network, promptly pays the merchant, and subtracts a fee. If a merchant wants to accept Amex credit cards—and attract Amex cardholders to its business—Amex requires the merchant to agree to an antisteering contractual provision. The antisteering provision prohibits merchants from discouraging customers from using their Amex card after they have already entered the store and are about to buy something, thereby avoiding Amex's fee. In this case, we must decide whether Amex's antisteering provisions violate federal antitrust law. We conclude they do not.

I

A

Credit cards have become a primary way that consumers in the United States purchase goods and services. When a cardholder uses a credit card to buy something from a merchant, the transaction is facilitated by a credit-card network. The network provides separate but interrelated services to both cardholders and merchants. For cardholders, the network extends them credit, which allows them to make purchases without cash and to defer payment until later. Cardholders also can receive rewards based on the amount of money they spend, such as airline miles, points for travel, or cash back. For merchants, the network allows them to avoid the cost of processing transactions and offers them quick, guaranteed payment. This saves merchants the trouble and risk of extending credit to customers, and it increases the number and value of sales that they can make.

By providing these services to cardholders and merchants, credit-card companies bring these parties together, and therefore operate what economists call a "two-sided platform." As the name implies, a two-sided platform offers different products or services to two different groups who both

depend on the platform to intermediate between them. See Evans & Schmalensee, Markets With Two–Sided Platforms, 1 Issues in Competition L. & Pol'y 667 (2008) (Evans & Schmalensee); Evans & Noel, Defining Antitrust Markets When Firms Operate Two–Sided Platforms, 2005 Colum. Bus. L. Rev. 667, 668 (Evans & Noel); Filistrucchi, Geradin, Van Damme, & Affeldt, Market Definition in Two–Sided Markets: Theory and Practice, 10 J. Competition L. & Econ. 293, 296 (2014) (Filistrucchi). For credit cards, that interaction is a transaction. Thus, credit-card networks are a special type of two-sided platform known as a "transaction" platform. See *id*., at 301, 304, 307; Evans & Noel 676–678. The key feature of transaction platforms is that they cannot make a sale to one side of the platform without simultaneously making a sale to the other. See Klein, Lerner, Murphy, & Plache, Competition in Two–Sided Markets: The Antitrust Economics of Payment Card Interchange Fees, 73 Antitrust L.J. 571, 580, 583 (2006) (Klein). For example, no credit-card transaction can occur unless both the merchant and the cardholder simultaneously agree to use the same credit-card network. See Filistrucchi 301.

Two-sided platforms differ from traditional markets in important ways. Most relevant here, two-sided platforms often exhibit what economists call "indirect network effects." Evans & Schmalensee 667. Indirect network effects exist where the value of the two-sided platform to one group of participants depends on how many members of a different group participate. D. Evans & R. Schmalensee, Matchmakers: The New Economics of Multisided Platforms 25 (2016). In other words, the value of the services that a two-sided platform provides increases as the number of participants on both sides of the platform increases. A credit card, for example, is more valuable to cardholders when more merchants accept it, and is more valuable to merchants when more cardholders use it. See Evans & Noel 686–687; Klein 580, 584. To ensure sufficient participation, two-sided platforms must be sensitive to the prices that they charge each side. See Evans & Schmalensee 675; Evans & Noel 680; Muris, Payment Card Regulation and the (Mis)Application of the Economics of Two–Sided Markets, 2005 Colum. Bus. L. Rev. 515, 532–533 (Muris); Rochet & Tirole, Platform Competition in Two–Sided Markets, 1 J. Eur. Econ. Assn. 990, 1013 (2003). Raising the price on side A risks losing participation on that side, which decreases the value of the platform to side B. If participants on side B leave due to this loss in value, then the platform has even less value to side A—risking a feedback loop of declining demand. See Evans & Schmalensee 675; Evans & Noel 680–681. Two-sided platforms therefore must take these indirect network effects into account before making a change in price on either side. See Evans & Schmalensee 675; Evans & Noel 680–681.[2]

Sometimes indirect network effects require two-sided platforms to charge one side much more than the other. See Evans & Schmalensee 667, 675, 681, 690–691; Evans & Noel 668, 691; Klein 585; Filistrucchi 300. For two-sided platforms, "'the [relative] price structure matters, and platforms must design it so as to bring both sides on board.' " Evans & Schmalensee 669 (quoting Rochet & Tirole, Two–Sided Markets: A Progress Report, 37 RAND J. Econ. 645, 646 (2006)). The optimal price might require charging the side with more elastic demand a below-cost (or even negative) price. See Muris 519, 550; Klein 579; Evans & Schmalensee 675; Evans & Noel 681. With credit cards, for example, networks often charge cardholders a lower fee than merchants because cardholders are more price sensitive.[3] See Muris 522; Klein 573–574, 585, 595. In fact, the network might well *lose* money on the cardholder side by offering rewards such as cash back, airline miles, or gift cards. See Klein 587; Evans & Schmalensee 672. The network can do this because increasing the number of cardholders increases the value of accepting the card to

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[2][1] In a competitive market, indirect network effects also encourage companies to take increased profits from a price increase on side A and spend them on side B to ensure more robust participation on that side and to stem the impact of indirect network effects. See Evans & Schmalensee 688; Evans & Noel 670–671, 695. Indirect network effects thus limit the platform's ability to raise overall prices and impose a check on its market power. See Evans & Schmalensee 688; Evans & Noel 695.

[3] [2] "Cardholders are more price-sensitive because many consumers have multiple payment methods, including alternative payment cards. Most merchants, by contrast, cannot accept just one major card because they are likely to lose profitable incremental sales if they do not take [all] the major payment cards. Because most consumers do not carry all of the major payment cards, refusing to accept a major card may cost the merchant substantial sales." Muris 522.

merchants and, thus, increases the number of merchants who accept it. Muris 522; Evans & Schmalensee 692. Networks can then charge those merchants a fee for every transaction (typically a percentage of the purchase price). Striking the optimal balance of the prices charged on each side of the platform is essential for two-sided platforms to maximize the value of their services and to compete with their rivals.

B

Amex, Visa, MasterCard, and Discover are the four dominant participants in the credit-card market. Visa, which is by far the largest, has 45% of the market as measured by transaction volume.[4] Amex and MasterCard trail with 26.4% and 23.3%, respectively, while Discover has just 5.3% of the market.

Visa and MasterCard have significant structural advantages over Amex. Visa and MasterCard began as bank cooperatives and thus almost every bank that offers credit cards is in the Visa or MasterCard network. This makes it very likely that the average consumer carries, and the average merchant accepts, Visa or MasterCard. As a result, the vast majority of Amex cardholders have a Visa or MasterCard, but only a small number of Visa and Master–Card cardholders have an Amex. Indeed, Visa and MasterCard account for more than 432 million cards in circulation in the United States, while Amex has only 53 million. And while 3.4 million merchants at 6.4 million locations accept Amex, nearly three million more locations accept Visa, MasterCard, and Discover.[5]

Amex competes with Visa and MasterCard by using a different business model. While Visa and MasterCard earn half of their revenue by collecting interest from their cardholders, Amex does not. Amex instead earns most of its revenue from merchant fees. Amex's business model thus focuses on cardholder spending rather than cardholder lending. To encourage cardholder spending, Amex provides better rewards than other networks. Due to its superior rewards, Amex tends to attract cardholders who are wealthier and spend more money. Merchants place a higher value on these cardholders, and Amex uses this advantage to recruit merchants.

Amex's business model has significantly influenced the credit-card market. To compete for the valuable cardholders that Amex attracts, both Visa and MasterCard have introduced premium cards that, like Amex, charge merchants higher fees and offer cardholders better rewards. To maintain their lower merchant fees, Visa and MasterCard have created a sliding scale for their various cards—charging merchants less for low-reward cards and more for high-reward cards. This differs from Amex's strategy, which is to charge merchants the same fee no matter the rewards that its card offers. Another way that Amex has influenced the credit-card market is by making banking and card-payment services available to low-income individuals, who otherwise could not qualify for a credit card and could not afford the fees that traditional banks charge. In sum, Amex's business model has stimulated competitive innovations in the credit-card market, increasing the volume of transactions and improving the quality of the services.

Despite these improvements, Amex's business model sometimes causes friction with merchants. To maintain the loyalty of its cardholders, Amex must continually invest in its rewards program. But, to fund those investments, Amex must charge merchants higher fees than its rivals. Even though Amex's investments benefit merchants by encouraging cardholders to spend more money, merchants would prefer not to pay the higher fees. One way that merchants try to avoid them, while still enticing Amex's cardholders to shop at their stores, is by dissuading cardholders from using Amex at the point of sale. This practice is known as "steering."

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[4] [3] All figures are accurate as of 2013.

[5] [4] Discover entered the credit-card market several years after Amex, Visa, and MasterCard. It nonetheless managed to gain a foothold because Sears marketed Discover to its already significant base of private-label cardholders. Discover's business model shares certain features with Amex, Visa, and MasterCard. Like Amex, Discover interacts directly with its cardholders. But like Visa and MasterCard, Discover uses banks that cooperate with its network to interact with merchants.

Amex has prohibited steering since the 1950s by placing antisteering provisions in its contracts with merchants. These antisteering provisions prohibit merchants from implying a preference for non-Amex cards; dissuading customers from using Amex cards; persuading customers to use other cards; imposing any special restrictions, conditions, disadvantages, or fees on Amex cards; or promoting other cards more than Amex. The antisteering provisions do not, however, prevent merchants from steering customers toward debit cards, checks, or cash.

C

In October 2010, the United States and several States (collectively, plaintiffs) sued Amex, claiming that its antisteering provisions violate § 1 of the Sherman Act.[6] After a 7–week trial, the District Court agreed that Amex's antisteering provisions violate § 1. It found that the credit-card market should be treated as two separate markets—one for merchants and one for cardholders. Evaluating the effects on the merchant side of the market, the District Court found that Amex's antisteering provisions are anticompetitive because they result in higher merchant fees.

The Court of Appeals for the Second Circuit reversed….

II

… In this case, both sides correctly acknowledge that Amex's antisteering provisions are vertical restraints … [and] that, like nearly every other vertical restraint, the antisteering provisions should be assessed under the rule of reason.

To determine whether a restraint violates the rule of reason, the parties agree that a three-step, burden-shifting framework applies. Under this framework, the plaintiff has the initial burden to prove that the challenged restraint has a substantial anticompetitive effect that harms consumers in the relevant market. If the plaintiff carries its burden, then the burden shifts to the defendant to show a procompetitive rationale for the restraint. If the defendant makes this showing, then the burden shifts back to the plaintiff to demonstrate that the procompetitive efficiencies could be reasonably achieved through less anticompetitive means.

Here, the parties ask us to decide whether the plaintiffs have carried their initial burden of proving that Amex's antisteering provisions have an anticompetitive effect. The plaintiffs can make this showing directly or indirectly. Direct evidence of anticompetitive effects would be "'proof of actual detrimental effects [on competition],'" *Indiana Dentists,* such as reduced output, increased prices, or decreased quality in the relevant market. Indirect evidence would be proof of market power plus some evidence that the challenged restraint harms competition.

Here, the plaintiffs rely exclusively on direct evidence to prove that Amex's antisteering provisions have caused anticompetitive effects in the credit-card market.[7] To assess this evidence, we must first define the relevant market. Once defined, it becomes clear that the plaintiffs' evidence is insufficient to carry their burden.

A

Because "[l]egal presumptions that rest on formalistic distinctions rather than actual market realities are generally disfavored in antitrust law," *Kodak*, courts usually cannot properly apply the rule of reason without an accurate definition of the relevant market.[8] "Without a definition of

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[6] [5] Plaintiffs also sued Visa and MasterCard, claiming that their antisteering provisions violated § 1. But Visa and MasterCard voluntarily revoked their antisteering provisions and are no longer parties to this case.

[7] [6] Although the plaintiffs relied on indirect evidence below, they have abandoned that argument in this Court.

[8] [7] The plaintiffs argue that we need not define the relevant market in this case because they have offered actual evidence of adverse effects on competition—namely, increased merchant fees. We disagree. The cases that the plaintiffs cite for this proposition evaluated whether horizontal restraints had an adverse effect on competition. See *Indiana Dentists; Catalano*. Given that horizontal restraints involve agreements between competitors not to compete in some way, this Court concluded that it did not need to precisely define the relevant market to conclude that these agreements were anticompetitive. But vertical restraints are different. Vertical restraints often pose no risk to competition unless the entity imposing them has market power, which cannot be evaluated unless the Court first defines the relevant market.

[the] market there is no way to measure [the defendant's] ability to lessen or destroy competition." Thus, the relevant market is defined as "the area of effective competition." Typically this is the "arena within which significant substitution in consumption or production occurs." But courts should "combin[e]" different products or services into "a single market" when "that combination reflects commercial realities."

As explained, credit-card networks are two-sided platforms. Due to indirect network effects, two-sided platforms cannot raise prices on one side without risking a feedback loop of declining demand. See Evans & Schmalensee 674–675; Evans & Noel 680–681. And the fact that two-sided platforms charge one side a price that is below or above cost reflects differences in the two sides' demand elasticity, not market power or anticompetitive pricing. See Klein 574, 595, 598, 626. Price increases on one side of the platform likewise do not suggest anticompetitive effects without some evidence that they have increased the overall cost of the platform's services. See *id.,* at 575, 594, 626. Thus, courts must include both sides of the platform—merchants and cardholders—when defining the credit-card market.

To be sure, it is not always necessary to consider both sides of a two-sided platform. A market should be treated as one sided when the impacts of indirect network effects and relative pricing in that market are minor. See Filistrucchi 321–322. Newspapers that sell advertisements, for example, arguably operate a two-sided platform because the value of an advertisement increases as more people read the newspaper. *Id.*, at 297, 315; Klein 579. But in the newspaper-advertisement market, the indirect networks effects operate in only one direction; newspaper readers are largely indifferent to the amount of advertising that a newspaper contains. See Filistrucchi 321, 323, and n. 99; Klein 583. Because of these weak indirect network effects, the market for newspaper advertising behaves much like a one-sided market and should be analyzed as such. See Filistrucchi 321; *Times–Picayune Publishing Co. v. United States,* 345 U.S. 594, 610 (1953).

But two-sided transaction platforms, like the credit-card market, are different. These platforms facilitate a single, simultaneous transaction between participants. For credit cards, the network can sell its services only if a merchant and cardholder both simultaneously choose to use the network. Thus, whenever a credit-card network sells one transaction's worth of card-acceptance services to a merchant it also must sell one transaction's worth of card-payment services to a cardholder. It cannot sell transaction services to either cardholders or merchants individually. See Klein 583 ("Because cardholders and merchants jointly consume a single product, payment card transactions, their consumption of payment card transactions must be directly proportional"). To optimize sales, the network must find the balance of pricing that encourages the greatest number of matches between cardholders and merchants.

Because they cannot make a sale unless both sides of the platform simultaneously agree to use their services, two-sided transaction platforms exhibit more pronounced indirect network effects and interconnected pricing and demand. Transaction platforms are thus better understood as "suppl[ying] only one product"—transactions. Klein 580. In the credit-card market, these transactions "are jointly consumed by a cardholder, who uses the payment card to make a transaction, and a merchant, who accepts the payment card as a method of payment." *Ibid.* Tellingly, credit cards determine their market share by measuring the volume of transactions they have sold.[9]

Evaluating both sides of a two-sided transaction platform is also necessary to accurately

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[9] [8] Contrary to the dissent's assertion, merchant services and cardholder services are not complements. See Filistrucchi 297 ("[A] two-sided market [is] different from markets for complementary products, in which both products are bought by the same buyers, who, in their buying decisions, can therefore be expected to take into account both prices"). As already explained, credit-card companies are best understood as supplying only one product—transactions—which is jointly consumed by a cardholder and a merchant. See Klein 580. Merchant services and cardholder services are both inputs to this single product. See *ibid*.

assess competition. Only other two-sided platforms can compete with a two-sided platform for transactions. See Filistrucchi 301. A credit-card company that processed transactions for merchants, but that had no cardholders willing to use its card, could not compete with Amex. See *ibid.* Only a company that had both cardholders and merchants willing to use its network could sell transactions and compete in the credit-card market. Similarly, if a merchant accepts the four major credit cards, but a cardholder only uses Visa or Amex, only those two cards can compete for the particular transaction. Thus, competition cannot be accurately assessed by looking at only one side of the platform in isolation.[10]

For all these reasons, “[i]n two-sided transaction markets, only one market should be defined.” *Id*., at 302; see also Evans & Noel 671 (“[F]ocusing on one dimension of ... competition tends to distort the competition that actually exists among [two-sided platforms]”). Any other analysis would lead to “‘“mistaken inferences”’” of the kind that could “‘“chill the very conduct the antitrust laws are designed to protect.”’” *Brooke Group*; see also *Matsushita Elec.* (“‘[W]e must be concerned lest a rule or precedent that authorizes a search for a particular type of undesirable pricing behavior end up by discouraging legitimate price competition’”); *Leegin* (noting that courts should avoid “increas[ing] the total cost of the antitrust system by prohibiting procompetitive conduct the antitrust laws should encourage”). Accordingly, we will analyze the two-sided market for credit-card transactions as a whole to determine whether the plaintiffs have shown that Amex's antisteering provisions have anticompetitive effects.

B

The plaintiffs have not carried their burden to prove anticompetitive effects in the relevant market. The plaintiffs stake their entire case on proving that Amex's agreements increase merchant fees. We find this argument unpersuasive.

As an initial matter, the plaintiffs' argument about merchant fees wrongly focuses on only one side of the two-sided credit-card market. As explained, the credit-card market must be defined to include both merchants and cardholders. Focusing on merchant fees alone misses the mark because the product that credit-card companies sell is transactions, not services to merchants, and the competitive effects of a restraint on transactions cannot be judged by looking at merchants alone. Evidence of a price increase on one side of a two-sided transaction platform cannot by itself demonstrate an anticompetitive exercise of market power. To demonstrate anticompetitive effects on the two-sided credit-card market as a whole, the plaintiffs must prove that Amex's antisteering provisions increased the cost of credit-card transactions above a competitive level, reduced the number of credit-card transactions, or otherwise stifled competition in the credit-card market. They failed to do so.

1

The plaintiffs did not offer any evidence that the price of credit-card transactions was higher than the price one would expect to find in a competitive market. As the District Court found, the plaintiffs failed to offer any reliable measure of Amex's transaction price or profit margins. And the evidence about whether Amex charges more than its competitors was ultimately inconclusive

Amex's increased merchant fees reflect increases in the value of its services and the cost of its transactions, not an ability to charge above a competitive price. Amex began raising its merchant fees in 2005 after Visa and MasterCard raised their fees in the early 2000s. As explained, Amex has historically charged higher merchant fees than these competitors because it delivers wealthier cardholders who spend more money. Amex's higher merchant fees are based on a careful study of how much additional value its cardholders offer merchants. On the other side of the market, Amex uses its higher merchant fees to offer its cardholders a more robust

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[10] [9] Nontransaction platforms, by contrast, often do compete with companies that do not operate on both sides of their platform. A newspaper that sells advertising, for example, might have to compete with a television network, even though the two do not meaningfully compete for viewers. See Filistrucchi 301.

rewards program, which is necessary to maintain cardholder loyalty and encourage the level of spending that makes Amex valuable to merchants. That Amex allocates prices between merchants and cardholders differently from Visa and MasterCard is simply not evidence that it wields market power to achieve anticompetitive ends. See Evans & Noel 670–671; Klein 574–575, 594–595, 598, 626.

In addition, the evidence that does exist cuts against the plaintiffs' view that Amex's antisteering provisions are the cause of any increases in merchant fees. Visa and MasterCard's merchant fees have continued to increase, even at merchant locations where Amex is not accepted and, thus, Amex's antisteering provisions do not apply. This suggests that the cause of increased merchant fees is not Amex's antisteering provisions, but rather increased competition for cardholders and a corresponding marketwide adjustment in the relative price charged to merchants. See Klein 575, 609.

2

The plaintiffs did offer evidence that Amex increased the percentage of the purchase price that it charges merchants by an average of 0.09% between 2005 and 2010 and that this increase was not entirely spent on cardholder rewards. The plaintiffs believe that this evidence shows that the price of Amex's transactions increased.

Even assuming the plaintiffs are correct, this evidence does not prove that Amex's antisteering provisions gave it the power to charge anticompetitive prices. "Market power is the ability to raise price profitably *by restricting output*." Areeda & Hovenkamp § 5.01 (emphasis added); accord, *Kodak; Business Electronics,* 485 U.S., at 723. This Court will "not infer competitive injury from price and output data absent some evidence that tends to prove that output was restricted or prices were above a competitive level." *Brooke*. There is no such evidence in this case. The output of credit-card transactions grew dramatically from 2008 to 2013, increasing 30%. "Where ... output is expanding at the same time prices are increasing, rising prices are equally consistent with growing product demand." *Brooke*. And, as previously explained, the plaintiffs did not show that Amex charged more than its competitors.

3

The plaintiffs also failed to prove that Amex's antisteering provisions have stifled competition among credit-card companies. To the contrary, while these agreements have been in place, the credit-card market experienced expanding output and improved quality. Amex's business model spurred Visa and MasterCard to offer new premium card categories with higher rewards. And it has increased the availability of card services, including free banking and card-payment services for low-income customers who otherwise would not be served. Indeed, between 1970 and 2001, the percentage of households with credit cards more than quadrupled, and the proportion of households in the bottom-income quintile with credit cards grew from just 2% to over 38%. See D. Evans & R. Schmalensee, Paying With Plastic: The Digital Revolution in Buying and Borrowing 88–89 (2d ed. 2005) (Paying With Plastic).

Nor have Amex's antisteering provisions ended competition between credit-card networks with respect to merchant fees. Instead, fierce competition between networks has constrained Amex's ability to raise these fees and has, at times, forced Amex to lower them. For instance, when Amex raised its merchant prices between 2005 and 2010, some merchants chose to leave its network. And when its remaining merchants complained, Amex stopped raising its merchant prices. In another instance in the late 1980s and early 1990s, competition forced Amex to offer lower merchant fees to "everyday spend" merchants—supermarkets, gas stations, pharmacies, and the like—to persuade them to accept Amex.

In addition, Amex's competitors have exploited its higher merchant fees to their advantage. By charging lower merchant fees, Visa, MasterCard, and Discover have achieved broader merchant acceptance—approximately 3 million more locations than Amex. This broader

merchant acceptance is a major advantage for these networks and a significant challenge for Amex, since consumers prefer cards that will be accepted everywhere. And to compete even further with Amex, Visa and MasterCard charge different merchant fees for different types of cards to maintain their comparatively lower merchant fees and broader acceptance. Over the long run, this competition has created a trend of declining merchant fees in the credit-card market. In fact, since the first credit card was introduced in the 1950s, merchant fees—including Amex's merchant fees—have decreased by more than half.

Lastly, there is nothing inherently anticompetitive about Amex's antisteering provisions. These agreements actually stem negative externalities in the credit-card market and promote interbrand competition. When merchants steer cardholders away from Amex at the point of sale, it undermines the cardholder's expectation of "welcome acceptance"—the promise of a frictionless transaction. A lack of welcome acceptance at one merchant makes a cardholder less likely to use Amex at all other merchants. This externality endangers the viability of the entire Amex network. And it undermines the investments that Amex has made to encourage increased cardholder spending, which discourages investments in rewards and ultimately harms both cardholders and merchants. Cf. *Leegin* (recognizing that vertical restraints can prevent retailers from free riding and thus increase the availability of "tangible or intangible services or promotional efforts" that enhance competition and consumer welfare). Perhaps most importantly, antisteering provisions do not prevent Visa, MasterCard, or Discover from competing against Amex by offering lower merchant fees or promoting their broader merchant acceptance.[11]

In sum, the plaintiffs have not satisfied the first step of the rule of reason. They have not carried their burden of proving that Amex's antisteering provisions have anticompetitive effects. Amex's business model has spurred robust interbrand competition and has increased the quality and quantity of credit-card transactions. And it is "[t]he promotion of interbrand competition," after all, that "is ... 'the primary purpose of the antitrust laws.' " *Id.*

* * *

Because Amex's antisteering provisions do not unreasonably restrain trade, we affirm the judgment of the Court of Appeals.

■ Justice BREYER, with whom Justice GINSBURG, Justice SOTOMAYOR, and Justice KAGAN join, dissenting. . . .

Because the majority devotes little attention to the District Court's detailed factual findings, I will summarize some of the more significant ones here. Among other things, the District Court found that beginning in 2005 and during the next five years, American Express raised the prices it charged merchants on 20 separate occasions. In doing so, American Express did not take account of the possibility that large merchants would respond to the price increases by encouraging shoppers to use a different credit card because the nondiscrimination provisions prohibited any such steering. The District Court pointed to merchants' testimony stating that, had it not been for those provisions, the large merchants would have responded to the price increases by encouraging customers to use other, less-expensive cards.

The District Court also found that even though American Express raised its merchant prices 20 times in this 5–year period, it did not lose the business of any large merchant. Nor did American Express increase benefits (or cut credit-card prices) to American Express cardholders in tandem with the merchant price increases. Even had there been no direct evidence of injury to competition, American Express' ability to raise merchant prices without losing any meaningful

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[11] [10] The plaintiffs argue that *Topco* forbids any restraint that would restrict competition in part of the market—here, for example, merchant steering. *Topco* does not stand for such a broad proposition. *Topco* concluded that a horizontal agreement between competitors was unreasonable per se, even though the agreement did not extend to every competitor in the market. A horizontal agreement between competitors is markedly different from a vertical agreement that incidentally affects one particular method of competition

market share, in the District Court's view, showed that American Express possessed power in the relevant market.

The District Court also found that, in the absence of the provisions, prices to merchants would likely have been lower. It wrote that in the late 1990's, Discover, one of American Express' competitors, had tried to develop a business model that involved charging lower prices to merchants than the other companies charged. Discover then invited each "merchant to save money by shifting volume to Discover," while simultaneously offering merchants additional discounts "if they would steer customers to Discover." The court determined that these efforts failed because of American Express' (and the other card companies') "nondiscrimination provisions." These provisions, the court found, "denied merchants the ability to express a preference for Discover or to employ any other tool by which they might steer share to Discover's lower-priced network." Because the provisions eliminated any advantage that lower prices might produce, Discover "abandoned its low-price business model" and raised its merchant fees to match those of its competitors. This series of events, the court concluded was "emblematic of the harm done to the competitive process" by the "nondiscrimination provisions."

The District Court added that it found no offsetting pro-competitive benefit to shoppers. Indeed, it found no offsetting benefit of any kind….

The majority, like the Court of Appeals, says that the District Court should have looked not only at the market for the card companies' merchant-related services but also at the market for the card companies' shopper-related services, and that it should have combined them, treating them as a single market. But I am not aware of any support for that view in antitrust law. Indeed, this Court has held to the contrary.

In *Times–Picayune Publishing Co. v. United States,* 345 U.S. 594, 610 (1953), … [w]e explained that "every newspaper is a dual trader in separate though interdependent markets; it sells the paper's news and advertising content to its readers; in effect that readership is in turn sold to the buyers of advertising space." We then added:

> "This case concerns solely one of those markets. The Publishing Company stands accused not of tying sales to its readers but only to buyers of general and classified space in its papers. For this reason, dominance in the advertising market, not in readership, must be decisive in gauging the legality of the Company's unit plan." *Ibid.*

Here, American Express stands accused not of limiting or harming competition for shopper-related card services, but only of merchant-related card services, because the challenged contract provisions appear only in American Express' contracts with merchants. That is why the District Court was correct in considering, at step 1, simply whether the agreement had diminished competition in merchant-related services….

Once a court has identified the good or service directly restrained, as *Times–Picayune Publishing Co.* requires, it will sometimes add to the relevant market what economists call "substitutes": other goods or services that are reasonably substitutable for that good or service. See, *e.g., du Pont*. The reason that substitutes are included in the relevant market is that they restrain a firm's ability to profitably raise prices, because customers will switch to the substitutes rather than pay the higher prices. See 2B Areeda & Hovenkamp ¶ 561, at 378.

But while the market includes substitutes, it does not include what economists call complements: goods or services that are used together with the restrained product, but that cannot be substituted for that product. See *id.,* ¶ 565a, at 429; *Kodak*. An example of complements is gasoline and tires. A driver needs both gasoline and tires to drive, but they are not substitutes for each other, and so the sale price of tires does not check the ability of a gasoline firm (say a gasoline monopolist) to raise the price of gasoline above competitive levels. As a treatise on the subject states: "Grouping complementary goods into the same market" is "economic nonsense," and would "undermin[e] the rationale for the policy against monopolization or collusion in the

first place." 2B Areeda & Hovenkamp ¶ 565a, at 431.

Here, the relationship between merchant-related card services and shopper-related card services is primarily that of complements, not substitutes. Like gasoline and tires, both must be purchased for either to have value. Merchants upset about a price increase for merchant-related services cannot avoid that price increase by becoming cardholders, in the way that, say, a buyer of newspaper advertising can switch to television advertising or direct mail in response to a newspaper's advertising price increase. The two categories of services serve fundamentally different purposes. And so, also like gasoline and tires, it is difficult to see any way in which the price of shopper-related services could act as a check on the card firm's sale price of merchant-related services. If anything, a lower price of shopper-related card services is likely to cause more shoppers to use the card, and increased shopper popularity should make it *easier* for a card firm to raise prices to merchants, not *harder,* as would be the case if the services were substitutes. Thus, unless there is something unusual about this case—a possibility I discuss below—there is no justification for treating shopper-related services and merchant-related services as if they were part of a single market, at least not at step 1 of the "rule of reason."…

Regardless, a discussion of market definition was legally unnecessary at step 1. That is because the District Court found strong *direct* evidence of anticompetitive effects flowing from the challenged restraint…. [T]his Court has stated that "[s]ince the purpose of the inquiries into market definition and market power is to determine whether an arrangement has the potential for genuine adverse effects on competition, proof of actual detrimental effects ... can obviate the need for" those inquiries. *Indiana Dentists*. That statement is fully applicable here….

One critical point that the majority's argument ignores is that proof of actual adverse effects on competition *is, a fortiori,* proof of market power. Without such power, the restraints could not have brought about the anticompetitive effects that the plaintiff proved. See *Indiana Dentists* ("[T]he purpose of the inquiries into market definition and market power is to determine *whether an arrangement has the potential for* genuine adverse effects on competition" (emphasis added)). The District Court's findings of actual anticompetitive harm from the nondiscrimination provisions thus showed that, whatever the relevant market might be, American Express had enough power in that market to cause that harm. There is no reason to require a separate showing of market definition and market power under such circumstances. And so the majority's extensive discussion of market definition is legally unnecessary….

The majority's discussion of market definition is also wrong…. Missing from the majority's analysis is any explanation as to *why,* given the purposes that market definition serves in antitrust law, the fact that a credit-card firm can be said to operate a "two-sided transaction platform" means that its merchant-related and shopper-related services should be combined into a single market…. The majority defines the phrase as covering a business that "offers different products or services to two different groups who both depend on the platform to intermediate between them," where the business "cannot make a sale to one side of the platform without simultaneously making a sale to the other" side of the platform. I take from that definition that there are four relevant features of such businesses on the majority's account: they (1) offer different products or services, (2) to different groups of customers, (3) whom the "platform" connects, (4) in simultaneous transactions.

What is it about businesses with those four features that the majority thinks justifies a special market-definition approach for them? It cannot be the first two features—that the company sells different products to different groups of customers. Companies that sell multiple products to multiple types of customers are commonplace. A firm might mine for gold, which it refines and sells both to dentists in the form of fillings and to investors in the form of ingots. Or, a firm might drill for both oil and natural gas. Or a firm might make both ignition switches inserted into auto bodies and tires used for cars. I have already explained that, ordinarily, antitrust law will not group the two nonsubstitutable products together for step 1 purposes.

Supra, at 2295 – 2296….

The majority disputes my characterization of merchant-related and shopper-related services as "complements." The majority relies on an academic article which devotes one sentence to the question, saying that "a two-sided market [is] different from markets for complementary products [*e.g.,* tires and gas], in which both products are bought by the same buyers, who, in their buying decisions, can therefore be expected to take into account both prices." Filistrucchi at 297.... But the distinction the majority mentions has nothing to do with the relevant question. The relevant question is whether merchant-related and shopper-related services are *substitutes,* one for the other, so that customers can respond to a price increase for one service by switching to the other service…

What about the last two features—that the company connects the two groups of customers to each other, in simultaneous transactions? That, too, is commonplace. Consider a farmers' market. It brings local farmers and local shoppers together, and transactions will occur only if a farmer and a shopper simultaneously agree to engage in one. Should courts abandon their ordinary step 1 inquiry if several competing farmers' markets in a city agree that only certain kinds of farmers can participate, or if a farmers' market charges a higher fee than its competitors do and prohibits participating farmers from raising their prices to cover it? Why? If farmers' markets are special, what about travel agents that connect airlines and passengers? What about internet retailers, who, in addition to selling their own goods, allow (for a fee) other goods-producers to sell over their networks? Each of those businesses seems to meet the majority's four-prong definition.

Apparently as its justification for applying a special market-definition rule to "two-sided transaction platforms," the majority explains that such platforms "often exhibit" what it calls "indirect network effects." By this, the majority means that sales of merchant-related card services and (different) shopper-related card services are interconnected, in that increased merchant-buyers mean increased shopper-buyers (the more stores in the card's network, the more customers likely to use the card), and vice versa. But this, too, is commonplace. Consider, again, a farmers' market. The more farmers that participate (within physical and esthetic limits), the more customers the market will likely attract, and vice versa. So too with travel agents: the more airlines whose tickets a travel agent sells, the more potential passengers will likely use that travel agent, and the more potential passengers that use the travel agent, the easier it will likely be to convince airlines to sell through the travel agent. And so forth. Nothing in antitrust law, to my knowledge, suggests that a court, when presented with an agreement that restricts competition in any one of the markets my examples suggest, should abandon traditional market-definition approaches and include in the relevant market services that are complements, not substitutes, of the restrained good….

What about the academic articles the majority cites? The first thing to note is that the majority defines "two-sided transaction platforms" much more broadly than the economists do. As the economists who coined the term explain, if a "two-sided market" meant simply that a firm connects two different groups of customers via a platform, then "pretty much any market would be two-sided, since buyers and sellers need to be brought together for markets to exist and gains from trade to be realized." Rochet & Tirole, Two–Sided Markets: A Progress Report, 37 RAND J. Econ. 645, 646 (2006). The defining feature of a "two-sided market," according to these economists, is that "the platform can affect the volume of transactions by charging more to one side of the market and reducing the price paid by the other side by an equal amount." *Id.,* at 664–665; accord, Filistrucchi 299. That requirement appears nowhere in the majority's definition. By failing to limit its definition to platforms that economists would recognize as "two sided" in the relevant respect, the majority carves out a much broader exception to the ordinary antitrust rules than the academic articles it relies on could possibly support.

Even as limited to the narrower definition that economists use, however, the academic

articles the majority cites do not support the majority's flat rule that firms operating "two-sided transaction platforms" should always be treated as part of a single market for all antitrust purposes. Rather, the academics explain that for market-definition purposes, "[i]n some cases, the fact that a business can be thought of as two-sided may be irrelevant," including because "nothing in the analysis of the practices [at issue] really hinges on the linkages between the demands of participating groups." Evans & Schmalensee, Markets With Two–Sided Platforms, 1 Issues in Competition L. & Pol'y 667, 689 (2008). "In other cases, the fact that a business is two-sided will prove important both by identifying the real dimensions of competition and focusing on sources of constraints." *Ibid.* That flexible approach, however, is precisely the one the District Court followed in this case, by considering the effects of "[t]he two-sided nature of the ... card industry" throughout its analysis,

Neither the majority nor the academic articles it cites offer any explanation for why the features of a "two-sided transaction platform" justify always treating it as a single antitrust market, rather than accounting for its economic features in other ways, as the District Court did….

Even if the majority were right to say that market definition was relevant, and even if the majority were right to further say that the District Court should have defined the market in this case to include shopper-related services as well as merchant-related services, that *still* would not justify the majority in affirming the Court of Appeals. That is because, as the majority is forced to admit, the plaintiffs *made* the factual showing that the majority thinks is required.

Recall why it is that the majority says that market definition matters: because if the relevant market includes both merchant-related services and card-related services, then the plaintiffs had the burden to show that as a result of the nondiscrimination provisions, "the price of credit-card transactions"—considering both fees charged to merchants and rewards paid to cardholders—"was higher than the price one would expect to find in a competitive market." ….

The problem with this reasoning, aside from it being wrong, is that the majority admits that the plaintiffs *did* show this: they "offer[ed] evidence" that American Express "increased the percentage of the purchase price that it charges merchants ... and that this increase was not entirely spent on cardholder rewards." Indeed, the plaintiffs did not merely "offer evidence" of this—they persuaded the District Court, which made an unchallenged factual finding that the merchant price increases that resulted from the nondiscrimination provisions "were not wholly offset by additional rewards expenditures or otherwise passed through to cardholders, and *resulted in a higher net price.*"

In the face of this problem, the majority retreats to saying that even net price increases do not matter after all, absent a showing of lower output, because if output is increasing, "'rising prices are equally consistent with growing product demand.'" This argument, unlike the price argument, has nothing to do with the credit-card market being a "two-sided transaction platform," so if this is the basis for the majority's holding, then nearly all of the opinion is dicta. The argument is also wrong. It is true as an economic matter that a firm exercises market power by restricting output in order to raise prices. But the relevant restriction of output is as compared with a hypothetical world in which the restraint was not present and prices were lower. The fact that credit-card use in general has grown over the last decade, as the majority says, says nothing about whether such use would have grown more or less without the nondiscrimination provisions. And because the relevant question is a comparison between reality and a hypothetical state of affairs, to require actual proof of reduced output is often to require the impossible—tantamount to saying that the Sherman Act does not apply at all.

In any event, there are features of the credit-card market that may tend to limit the usual relationship between price and output. In particular, merchants generally spread the costs of credit-card acceptance across all their customers (whatever payment method they may use), while the benefits of card use go only to the cardholders. Thus, higher credit-card merchant fees may

have only a limited effect on credit-card transaction volume, even as they disrupt the marketplace by extracting anticompetitive profits.

… American Express might wish to argue that the nondiscrimination provisions, while anticompetitive in respect to merchant-related services, nonetheless have an adequate offsetting procompetitive benefit in respect to its shopper-related services. I believe that American Express should have an opportunity to ask the Court of Appeals to consider that matter.

American Express might face an uphill battle. A Sherman Act § 1 defendant can rarely, if ever, show that a pro-competitive benefit in the market for one product offsets an anticompetitive harm in the market for another. In *United States v. Topco Associates, Inc.,* 405 U.S. 596, 611 (1972), this Court wrote:

> "If a decision is to be made to sacrifice competition in one portion of the economy for greater competition in another portion, this ... is a decision that must be made by Congress and not by private forces or by the courts. Private forces are too keenly aware of their own interests in making such decisions and courts are ill-equipped and ill-situated for such decisionmaking."…

Regardless, I would not now hold that an agreement such as the one before us can never be justified by procompetitive benefits of some kind. But the Court of Appeals would properly consider procompetitive justifications not at step 1, but at steps 2 and 3 of the "rule of reason" inquiry. American Express would need to show just how this particular anticompetitive merchant-related agreement has procompetitive benefits in the shopper-related market. In doing so, American Express would need to overcome the District Court's factual findings that the agreement had no such effects….

The majority charts a different path. Notwithstanding its purported acceptance of the three-step, burden-shifting framework I have described, the majority addresses American Express' procompetitive justifications now, at step 1 of the analysis. And in doing so, the majority inexplicably ignores the District Court's factual findings on the subject.

The majority reasons that the challenged nondiscrimination provisions "stem negative externalities in the credit-card market and promote interbrand competition." The "negative externality" the majority has in mind is this: If one merchant persuades a shopper not to use his American Express card at that merchant's store, that shopper becomes less likely to use his American Express card at other merchants' stores. The majority worries that this "endangers the viability of the entire [American Express] network," but if so that is simply a consequence of American Express' merchant fees being higher than a competitive market will support. "The antitrust laws were enacted for 'the protection of *competition,* not *competitors.*' " *Atlantic Richfield Co. v. USA Petroleum Co.,* 495 U.S. 328, 338 (1990). If American Express' merchant fees are so high that merchants successfully induce their customers to use other cards, American Express can remedy that problem by lowering those fees or by spending more on cardholder rewards so that cardholders decline such requests. What it may not do is demand contractual protection from price competition.

In any event, the majority ignores the fact that the District Court, in addition to saying what I have just said, also rejected this argument on independent factual grounds. It explained that American Express "presented no expert testimony, financial analysis, or other direct evidence establishing that without its [nondiscrimination provisions] it will, in fact, be unable to adapt its business to a more competitive market." It further explained that the testimony that was provided on the topic "was notably inconsistent," with some of American Express' witnesses saying only that invalidation of the provisions "would require American Express to adapt its current business model." After an extensive discussion of the record, the District Court found that "American Express possesses the flexibility and expertise necessary to adapt its business model to suit a market in which it is required to compete on both the cardholder and merchant sides of the [credit-

card] platform." The majority evidently rejects these factual findings, even though no one has challenged them as clearly erroneous.

Similarly, the majority refers to the nondiscrimination provisions as preventing "free riding" on American Express' "investments in rewards" for cardholders. But as the District Court explained, "[p]lainly ... investments tied to card use (such as Membership Rewards points, purchase protection, and the like) are not subject to free-riding, since the network does not incur any cost if the cardholder is successfully steered away from using his or her American Express card." This, I should think, is an unassailable conclusion: American Express pays rewards to cardholders only for transactions in which cardholders use their American Express cards, so if a steering effort succeeds, no rewards are paid. As for concerns about free riding on American Express' fixed expenses, including its investments in its brand, the District Court acknowledged that free-riding was in theory possible, but explained that American Express "ma[de] no effort to identify the fixed expenses to which its experts referred or to explain how they are subject to free riding." The majority does not even acknowledge, much less reject, these factual findings, despite coming to the contrary conclusion.

Finally, the majority reasons that the nondiscrimination provisions "do not prevent Visa, MasterCard, or Discover from competing against [American Express] by offering lower merchant fees or promoting their broader merchant acceptance." But again, the District Court's factual findings were to the contrary. As I laid out above, the District Court found that the nondiscrimination provisions *in fact did prevent* Discover from pursuing a low-merchant-fee business model, by "den[ying] merchants the ability to express a preference for Discover or to employ any other tool by which they might steer share to Discover's lower-priced network." The majority's statements that the nondiscrimination provisions are procompetitive are directly contradicted by this and other factual findings….

NOTES AND QUESTIONS ON *OHIO V. AMERICAN EXPRESS*[12]

1. Does it make sense to hold that although anticompetitive effects can be shown directly or indirectly, they cannot be shown directly without proof of market definition in this case? The Supreme Court's first confirmed that, under *Indiana Dentists,* anticompetitive effects can either be proven directly or indirectly inferred from market power. But then the Court concluded that to determine whether anticompetitive effects existed in this case, it had to define the relevant market because the restraint at issue was vertical, and vertical restraints often pose no threat without market power, which the court said could not be evaluated without defining the market. *See* Opinion n.[7]. The problem with that logic is that the *Indiana Dentists* holding that direct or indirect proof could be used came in a portion of the opinion that assumed, for the sake of argument, that full-scale rule of reason applied, which is the same standard used for vertical restraints. Further, the reasoning of *Indiana Dentists* was that direct proof of anticompetitive effects obviates the need to prove market power because the latter is just a surrogate for inferring anticompetitive effects, and that reasoning applies equally to vertical restraints. Moreover, even if market power were required, that does not mean market definition is required since market power (even monopoly power) can be proven by directly showing a power to control prices or exclude competition.[13] Indeed, direct proof of

[12] Disclosure: Professor Elhauge was one of many amici professors who, pro bono, filed a brief in support of the plaintiffs before the Supreme Court in this case.

[13] See *supra* Chapter 3.B.2. Justice Thomas himself recognized this point in a prior opinion when he was a D.C. Circuit judge. *See* United States v. Baker Hughes, Inc., 908 F.2d 981, 992 (D.C.Cir. 1990) (Thomas, J., joined by Ruth Bader Ginsburg, J.). Other circuit courts have held the same. Todd v. Exxon, 275 F.3d 191, 206-07 (2d Cir. 2001)(Sotomayor, J); Allen-Myland v. IBM, 33 F.3d 194, 209 (3d Cir. 1994); Toys "R" Us v. FTC, 221 F.3d 928, 937 (7th Cir. 2000) (Wood, J.); In re Brand Name Prescription Drugs Anti-trust Litigation, 186 F.3d 781, 786 (7th Cir. 1999) (Posner, J.)); Re/Max International v. Realty One,

anticompetitive effects itself indicates market power because it would not be possible to impose anticompetitive effects without the market power to do so.

American Express thus seemed to use unsound reasoning to eliminate the direct proof branch of *Indiana Dentists* for vertical restraints. But this reasoning came in footnote dicta that is not binding and perhaps was not intended, given that the actual focus of the opinion provides a far more direct basis for the Court's holding that market definition was required in this case. Namely, in this case, the market definition issue was whether the market was two sided or not, and the answer to that question determined whether plaintiffs had provided direct proof of anticompetitive effects, given that proving anticompetitive effects in a two-sided market requires showing net negative effects to the combination of both sides of the market, rather than just showing harm to one side (here, merchants). In short, if the market definition issue is whether a market is two sided, then market definition must generally be assessed to determine what constitutes sufficient direct proof of anticompetitive effects. But this proposition should properly be limited to cases where the disputed market definition issue is whether the market is two sided. Further, even when the parties dispute whether the market is two sided, if direct proof were provided of anticompetitive harm not only to one side of the market but to the combination of both sides, that should obviate the need to define the market because anticompetitive effects would be directly proven regardless of whether the market were defined to be one sided or two sided.

2. Should a two-sided transaction platform be treated as a single market even though the two sides are not substitutes? Why not treat them as complements? Traditionally, two products were deemed to be in same market only if they were substitutes. Complements are products that are used together, but are not substitutes, like gasoline and tires. The Court reasoned that, in this case, the products differed from complements because they were not bought by the same buyers, who could take both prices into account when buying. *See* Opinion n.[8]. Instead, in this case the product involved one transaction that was jointly consumed by two actors. Although this is a factual distinction, it is unclear why that distinction should be relevant. The relevant economic factors would seem to be that the situation here is like standard complements in that the products are not substitutes, involve indirect network externalities, and have product demands that are affected by the products' relative prices. Given that similarity in economics, it is not clear why antitrust law should treat them differently.

3. How clear is it which two-sided platforms are single markets? The answer is not very clear. The Court did hold that if the two-sided platform is a two-sided *transaction* platform (i.e., a platform where a sale cannot be made to one side of the platform without simultaneously making a sale to the other, as for credit cards), then it must be evaluated as a single two-sided market. The Court further held that other two-sided platforms are not two-sided markets when indirect network effects are weak, and it concluded that they are weak at least in situations like the newspapers considered in *Times-Picayune,* where one side (there advertisers) cares about the number of participants on the other side (there readers), but the other side (there readers) does not care about the number of participants in the first side (there advertisers).

But it is not clear which other markets might be deemed two-sided transaction platforms, nor is it clear whether or when other two-sided platforms that do not involve simultaneous transactions might be deemed to have indirect network effects that are sufficiently strong to make them a single two-sided market. For example, should farmers' markets, travel agents, Amazon, Google, or Facebook be deemed two-sided transaction platforms? Even if not, should their indirect network effects nonetheless be deemed sufficiently strong to make each of them a single two-sided market?

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173 F.3d 995, 1018 (6th Cir. 1999) (so holding and collecting other supporting authorities in the First, Eighth, Ninth, and Tenth circuits, noting that only the Fifth Circuit has held the contrary).

4. If a market is a two-sided market, what evidence does the Court hold is required to show anticompetitive effects? The Court holds that, at least for two-sided transaction platforms, it is not enough to show a price increase to one side (such as a fee increase to merchants). Instead, for two-sided transaction platforms, the plaintiff must show that the restraint either: (1) increased the combined price for transactions above the competitive level; (2) reduced the output of transactions; or (3) stifled competition. Here, the relevant restraint was that Amex had antisteering provisions that prohibited merchants from steering customers away from Amex to other cards by, for example, adding surcharges for consumers who used Amex or giving discounts to consumers who used other cards.

a. Why doesn't the fact that the merchant fee increase exceeded the consumer rewards increase show that the combined net price for transactions increased? The Court reasoned in part that Amex's increased merchant fees reflected increased costs because Amex provided higher consumer rewards in order to compete with other credit cards. This reasoning did not really explain why the *difference* between Amex's merchant fees and consumer rewards had increased, nor why the two increased at different times. That evidence did show that the net price for transactions had increased even when one considered both sides of the market. But the Court suggested that such a net increase might have been needed to balance merchant demand and consumer demand. A more general explanation might be that if competition required spending more on consumer rewards to get more transactions, that would mean higher marginal costs, which would predictably lead to a higher net combined price for any constant degree of market power, given the standard Lerner Index market power pricing formula that $(P-C)/P = 1/\varepsilon$.

The Court also reasoned that merchant fees had also increased at locations where Amex was not accepted, which the Court thought suggested the fee increase were caused by a marketwide adjustment in relative prices, rather than by Amex's antisteering provisions. But Amex's antisteering provisions might well have increased marketwide fees by reducing price-based competition between credit cards, especially in combination with the fact that the other credit cards also had antisteering provisions that they had only recently revoked.

More generally, the Court concluded that any rise in transaction prices did not prove those prices were above the competitive levels that would have existed but for the challenged restraint because prices might have risen for other reasons, such as increased product demand.

b. Does the increase in the number of credit-card transactions from past levels show that the antisteering provisions did not reduce output? The Court thought it did. But that logic raised two issues. The first issue was whether the measure of output relevant for assessing anticompetitive effects was *credit-card* transactions or instead *retail* transactions. The dissent reasoned that, because the antisteering provisions prevented merchants from selectively charging higher retail prices to users of higher-priced cards, merchants were instead likely to cover higher merchant fees by raising retail prices to all their customers, which might have only a limited effect on credit-card transactions but could lower total retail transactions. One could go even further: because the antisteering provisions caused cardholders not to experience the fees that their particular card choice imposed on merchants, those provisions would likely cause consumers to use their cards more than they would in a competitive market, which could mean that the increase in credit-card transactions was affirmatively anticompetitive. To be sure, such anticompetitive effects might be constrained by fact that the antisteering provisions did allow merchants to steer customers to debit or cash transactions, but that constraint would be imperfect given that credit cards have distinctive advantages to consumers.

The second issue was that an increase in output from *past* levels does not prove an absence of anticompetitive effects, which instead turns on any differences from *but-for* levels (i.e., the levels that

would have existed but for the restraint).[14] Still, the burden to prove anticompetitive effects was on the plaintiffs, and the Court concluded that the evidence that both prices and output had increased over time was equally consistent with rising product demand. Thus, the plaintiffs failed to prove that output was lower than but-for levels, whether one measures output in retail transactions or credit-card transactions. The dissent stressed that it is often impossible to prove but-for output levels, so that antitrust law should instead focus on the price increase. But that did not rebut the Court's point that the increase from past price levels did not prove that prices rose above but-for competitive levels.

c. Why didn't the evidence show that competition was stifled? The Court thought that various pieces of the evidence showed that credit card competition was not stifled. ***First***, the Court stressed that Amex spurred Visa and Mastercard to offer cards with a higher consumer rewards. But Visa and Mastercard's offerings might themselves have been distorted by the anticompetitive effects of Amex's antisteering provisions. After all, Amex's high consumer rewards would tend to increase consumer use of Amex cards. But because steering was prohibited, rival credit cards could not hope to increase consumer use of their cards by lowering rival fees to merchants, other than in the rare case when that would cause merchants to drop Amex altogether. Thus, the antisteering provisions meant that the only effective way rivals could compete with Amex was by offering higher consumer rewards themselves, which would require higher merchant fees to offset those costs. This effect would tend to anticompetitively inflate the merchant fees and consumer rewards offered by all credit cards in the market.

Without any antisteering provisions, companies could instead compete by offering different menus of consumer rewards and merchant fees. Consumers would then be faced with both the benefits of those consumer rewards and (through steering surcharges and discounts) the costs of those merchant fees, and consumers would be free to pick the combination of rewards and fees that they found most competitively attractive. It is hard to see why preventing that choice from being offered did not stifle competition. Indeed, the district court found that the antisteering provisions prevented the Discover card from succeeding with a low consumer rewards-low merchant fees approach that otherwise would have been an attractive option for many merchants and consumers in an unrestrained market.

Second, the Court stressed evidence that higher merchant fees did have some effect on the number of merchants that took Amex. But any firm with market power, even monopoly power, loses some customers with higher prices, given that demand is rarely, if ever, totally inelastic and that even a total monopolist never prices on the inelastic portion of its demand curve. See *supra* Chapter 3.B.2. Accordingly, this evidence is hardly inconsistent with market power and a stifling of competition. Moreover, the district court found that increased Amex merchant fees did not lose Amex any large merchant or any meaningful market share and that the antisteering provisions reduced the ability of merchants to avoid higher prices. That evidence directly supported market power and a stifling of competition.

Third, the Court concluded that antisteering provisions prevented merchants from using surcharges or discounts at retail that might have undermined the welcome acceptance of Amex at retail stores, which in turn would have reduced Amex's incentives to invest in consumer rewards. However, merchant steering could encourage a customer to buy only if that customer also had a rival credit card, so Amex card acceptance could not be necessary to persuade the relevant set of customers to come into retail stores. Further, merchants were accepting Amex; they just wanted to make customers face the true cost of using Amex and then allow customers to decide which combination of price and rewards they preferred. The dissent also argued that using such merchant surcharges and discounts was not free riding, but rather just a competitive response to higher Amex prices. Moreover,

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[14] *See, e.g., NCAA*, 468 U.S. at 107 (anticompetitive consequences obtain when "[p]rice is higher and output lower than they *would otherwise be*.") (emphasis added).

Amex did not pay any consumer rewards when the customer did not use an Amex card, so steering customers to using a rival card could not cause free riding on any investment in those rewards. To be sure, in theory there could be free riding on any fixed expenses needed to offer consumer rewards, but Amex offered no evidence on such fixed expenses nor any explanation as to why they would be subject to free-riding problems.

A more general problem with the Court's assessment of this issue is that it involved a posited procompetitive effect, and thus the Court seemed to shift the burden of proving procompetitive effects onto plaintiffs by making disproving those procompetitive effects part of market definition, when the burden to show procompetitive effects was (as the Court stated at the outset) supposed to be on the defendants. The Court's analysis also seemed to ignore the district court's finding that there was no procompetitive benefit. Maybe the Court did so because the district court put the burden of proof on the defendants on this topic, and the Court thought the burden should be on the plaintiffs as part of market definition. But the district court's conclusion on procompetitive effects did not rest on the burden of proof; rather, it affirmatively found there was no free riding because Amex did not pay rewards when customers did not use an Amex card and no evidence existed of free riding on fixed expenses.

Another issue was that, as the plaintiffs stressed, the normal rule is that one cannot use procompetitive effects in one market to offset anticompetitive effects in another market. The Court concluded that this principle did not apply to vertical agreements that only affected one particular method of competition. *See* Opinion n.[10]. It is not clear whether the Court was limiting this exception to cases, like here, where both effects were in the same two-sided market, or whether the Court meant to extend this exception to any vertical agreements that might have differing effects on upstream versus downstream markets. Even the dissent indicated that a procompetitive benefit to consumers could be an admissible justification for the anticompetitive harm to merchants, suggesting that to some extent the dissent agreed that the markets were sufficiently interlinked so that one could not entirely separate their effects.

CHAPTER SEVEN

Insert: Replace pages 1145-1162 of "C. Vertical Mergers" with the following.

C. VERTICAL MERGERS

Vertical mergers have several possible anticompetitive effects. Some of those effects are foreclosure effects similar to those potentially caused by exclusive dealing, namely that the vertical merger might foreclose a sufficient share of suppliers or buyers to rivals that it impairs the ability of rivals to compete, and may even effectively require two-level entry to compete. Other effects reflect a mixture of concerns about unilateral incentives to increase prices and raising rivals' costs, such as that a vertical merger might create incentives to raise prices to downstream rivals in order to increase the profits of firm's own downstream outlet.[15] If there are few firms in the market, vertical mergers might also facilitate oligopolistic coordination among them by making their pricing more noticeable (such as when a manufacturer merges into retail) or because the merged firm can, as buyer, better monitor rival upstream pricing.

[15] *See* Serge Moresi & Steven C. Salop, *vGUPPI: Scoring Unilateral Pricing Incentives in Vertical Mergers*, 79 ANTITRUST L.J. 185 (2013).

Vertical mergers also raise the concern that they might eliminate potential horizontal competition, such as when the merging firms are likely to have entered each other's market absent the merger. We will, however, defer those issues to the section on conglomerate mergers, which centers more directly on that issue. Finally, vertical integration might facilitate price discrimination if the integrated firm is more able to stop any buyer resales that would otherwise undermine such price discrimination. Such price discrimination usually decreases consumer welfare. It also decreases total welfare if the distribution of consumer preferences is not too flat, but it increases total welfare if the distribution curve is fairly flat. *See* Chapter 3.

Absent such an anticompetitive effect, even firms with market power generally have no incentive to use vertical mergers to prevent vigorous competition upstream or downstream because their market power at any given stage is greater if other production or distribution stages are more efficient because that increases the value of the ultimate product to consumers. Vertical mergers can also have affirmatively procompetitive effects. In part, these effects are similar to the possible procompetitive effects from exclusive dealing. Vertical mergers can reduce uncertainty, eliminate free riding incentives between manufacturers and dealers in promoting a brand, or more generally encourage firm-specific investments, but do so in a way that systematically restricts opportunism rather than being limited to specific deals. Vertical mergers can also create other important additional efficiencies. Like horizontal mergers, vertical mergers can create integrative efficiencies, but they tend to be less economies of size and more economies of scope or synergies (like lowering costs by integrating vertical production). Further, where vertical mergers combine firms that have market or monopoly power in successive markets, they might eliminate double marginalization in a way that can avoid the lower output or inefficient substitution that it would otherwise cause.

In the United States, the current law on vertical mergers is obscure. In *Brown Shoe v. United States,* 370 U.S. 294 (1962), the Supreme Court condemned a vertical merger that foreclosed only 1.2% of the relevant market. But, while that case has never been overruled, it clearly does not reflect modern antitrust practice. To illustrate modern enforcement practices, the materials below focus on two modern cases that show how current adjudicators treat vertical mergers. U.S. agency enforcement on vertical mergers is also uncertain and varies sharply with different administrations. The 2020 Vertical Merger Guidelines that were adopted by the DOJ and FTC during the Trump Administration were withdrawn in 2021 by the FTC in a 3-2 party line vote during the Biden administration, with indications that the DOJ may follow. Even if the DOJ does join the FTC in withdrawing the 2020 guidelines, they remain relevant not only because their principles are likely to predict enforcement in future Republican administrations and might influence court decisions, but also because even the FTC majority that withdrew them regards them as useful and, as of the date of this writing, has not yet replaced them with new guidelines. To illuminate the key points currently being debated about vertical merger enforcement, the below thus includes excerpts both from the 2020 Vertical Merger Guidelines and from the FTC commissioner statements explaining why they favored or opposed withdrawing those guidelines.

In the EU, the Commission has on a number of occasions prohibited vertical mergers or authorized such mergers with corrective remedies because of their effects of possible exclusion of competitors. While the Commission has expressed concerns on the foreclosure of vertical mergers in a variety of fields, it is in the media and aviation sectors that it has taken particularly drastic measures (including several decisions of prohibitions) to avoid the potentially exclusionary effects of vertical concentrations. The current view of the Commission on vertical mergers can be found in its guidelines on non-horizontal mergers, which are excerpted below.

Like horizontal mergers, vertical mergers are also subject to efficiency and failing firm defenses. Entry barriers are also relevant at both the upstream and downstream levels.

In the Matter of Cadence Design Systems, Inc.

124 F.T.C. 131 (1997)

[Cadence, which made integrated circuit layout environments, wanted to acquire CCT, which made integrated circuit routing tools. The FTC charged the following in a complaint.] Integrated circuit layout environments are software infrastructures within which integrated circuit designers access integrated circuit layout tools, including . . . routing tools. . . . CCT is currently the only firm with a commercially viable . . . integrated circuit routing tool. At least one other firm with . . . routing-technology is in the process of developing [an] integrated circuit routing tool. Cadence is the dominant supplier of integrated circuit layout environments. Cadence's leading competitor in the supply of integrated circuit layout environments is the Avant! Corporation. Avant! and several of its top executives have been charged criminally with conspiracy and theft of trade secrets from Cadence.

There are substantial barriers to entry in the market for . . . integrated circuit routing tools, [which] . . . are technologically complex and difficult to develop. De novo entry takes approximately two to three and a half years for a company that already possesses certain underlying core technology that can be used to develop [an] integrated circuit router . . . Entry is likely to take even longer for a company that does not possess such technology.

In order to achieve the necessary compatibility between the integrated circuit layout tools that they use, integrated circuit designers select integrated circuit layout tools that have interfaces to a common integrated circuit layout environment. Since Cadence is the dominant supplier of integrated circuit layout environments, [an] integrated circuit routing tool that lacks an interface into a Cadence integrated circuit layout environment is less likely to be selected by integrated circuit designers than [an] integrated circuit routing tool that possesses an interface into a Cadence integrated circuit layout environment.

An integrated circuit layout environment is not likely to be selected by integrated circuit designers unless a full set of compatible integrated circuit layout tools is available. A full set of integrated circuit layout tools includes at least placement, routing, and analysis and verification tools, each of which must be able to interface into the integrated circuit layout environment that the integrated circuit designer has selected.

It is in Cadence's interest to make available to users of a Cadence integrated circuit layout environment a complete a set of integrated circuit layout tools, because to do so makes the Cadence integrated circuit layout environment more valuable to integrated circuit designers. Cadence historically has provided access to Cadence integrated circuit layout environments to suppliers of complementary integrated circuit layout tools that Cadence does not supply.

Cadence does not, however, have incentives to provide access to a Cadence integrated circuit layout environment to suppliers of integrated circuit layout tools that compete with Cadence products. Cadence historically has been reluctant to provide access to Cadence integrated circuit layout environments to suppliers of integrated circuit layout tools that compete with Cadence products.

Prior to the Proposed Merger, Cadence did not have a commercially viable . . . integrated circuit routing tool. As a result of the Proposed Merger, Cadence will own the only currently available commercially viable . . . integrated circuit routing tool. For this reason, the Proposed Merger will make Cadence less likely to permit potential suppliers of competing . . . integrated circuit routing tools to obtain access to Cadence integrated circuit layout environments. Without access to Cadence integrated circuit layout environments, developers are less likely to gain successful entry into the market for . . . integrated circuit routing tools.

The Proposed Merger will make it more likely that successful entry into the . . . integrated circuit routing tool market would require simultaneous entry into the market for integrated

circuit layout environments. This need for dual-level entry will decrease the likelihood of entry into the market for . . . integrated circuit routing tools.

The Proposed Merger may substantially lessen competition or tend to create a monopoly in the market for . . . integrated circuit routing tools. The Proposed Merger may, among other things, lead to higher prices, reduced service, and less innovation. . . .

DECISION AND ORDER

[Based on the above complaint, the FTC and merging parties entered into a consent order approving the merger on the conditions that for the next ten years Cadence: (1) had to provide other integrated circuit router tool companies with equal access to Cadence's "Connections Program," which provided independent software developers with the interfaces necessary to work with Cadence's integrated circuit layout, and (2) notify the FTC before acquiring another integrated circuit routing tool company.] . . .

■ **Statement of Chairman Robert Pitofsky & Commissioner Janet D. Steiger**.[16]

. . . The Commission's complaint alleges a well-established vertical theory of competitive harm, laid out in the 1984 Merger Guidelines. The Guidelines explain that a vertical merger can produce horizontal anticompetitive effects by making competitive entry less likely if (1) as a result of the merger, there is a need for simultaneous entry into two or more markets and (2) such simultaneous entry would make entry into the single market less likely to occur. While the dissenting Commissioners may take issue in this case with the "dual-level entry" theory of vertical mergers that the 1984 Guidelines articulate, the available evidence suggests that the Cadence/CCT merger, which combines Cadence's dominant position in integrated circuit layout environments with CCT's current monopolistic position in . . . integrated circuit routers, presents a straightforward case of anticompetitive effects caused by vertical integration. We believe that this type of competitive harm merits our attention.[4]

. . . [U]nless a would-be supplier of routing tools had the ability to develop an interface to the Cadence integrated circuit layout environment, it would not be able to market its routing product effectively to the vast majority of potential customers which use the Cadence layout environment. Without an expectation that it could design software compatible with Cadence's installed base, a would-be entrant might well decide not to compete.

After the Cadence/CCT merger, Cadence would have had an incentive to impede attempts by companies developing routing technology competitive with CCT's . . . router technology, IC Craftsman, to gain access to the Cadence integrated circuit layout environment. Following the merger, successful entry into the routing tool market is more likely to require simultaneous entry into the market for integrated circuit layout environments. Without a consent order that mandates access to Cadence's layout environment, and thus lowers the barriers to entry in the market, a combined Cadence/CCT will face less competitive pressure to innovate or to price aggressively. Thus, competition would likely be reduced as a result of the acquisition.

The remedy in this matter preserves opportunities for new entrants with integrated circuit routers competitive with IC Craftsman by allowing them to interface with Cadence's layout environments on the same terms as developers of complementary design tools. Specifically, the order requires Cadence to allow independent commercial router developers to build interfaces between their design tools and the Cadence layout environment through Cadence's "Connections

[16] Commissioner Varney initially joined this statement when it was issued for public comment, but left the FTC before this statement was finalized.

[4] Contrary to Commissioner Starek's assertions that enforcement action here, in the context of a merger, leads logically to enforcement action against internal vertical expansion, . . . such unilateral action has been known to present a completely different set of questions under the antitrust laws for more than one hundred years.

Program." The Connections Program is in place now and has more than one hundred participants who have all entered a standard form contract with Cadence. . . .

The dissenting statements fail to give full weight to all the incentives at work in the vertical case. It is true that Cadence would be motivated by the entry of new, promising routing technology to allow an interface to its layout environment to sell more of its complementary products. And absent the merger, that would be its only incentive. But with the merger, Cadence clearly also has an incentive to prevent loss of sales in its competing products. And while these two incentives may compete as a theoretical matter, the evidence in this case indicated that Cadence has acted historically according to the latter incentive. There is some reason to believe that Cadence in the past has thwarted attempts by firms offering potentially competitive technology to develop interfaces to its layout environment (including at one point, CCT). Now that it has a satisfactory router to offer its customers, there is no reason to think that absent the consent order, Cadence would treat developers of routers that would compete with IC Craftsman any differently than it once treated CCT.

Commissioner Azcuenaga also suggests that the consent order is unnecessary because a company developing a router to compete with IC Craftsman could proceed, as CCT did, without an interface to Cadence's design layout environment. The evidence showed, however, that CCT's management thought that ensuring compatibility with Cadence's layout environment was critical and that marketing without that compatibility, which it had done, was not sufficient. It took the extreme measure of inducing a third party to write software for CCT to interface IC Craftsman with the Cadence layout environment without Cadence's knowledge. Moreover, despite CCT's success in developing a routing program, its sales of IC Craftsman were quite modest before it obtained an authorized interface with the Cadence environment.

Commissioner Azcuenaga is further concerned that mandating access to the Connections Program for developers of routing software on terms as favorable as for other Connections participants might have unintended consequences. In particular, she is concerned that the order may prompt Cadence to charge higher prices to all Connections partners. But the Connections Program is an existing program with over one hundred members, and Cadence would have significant logistical difficulties, and would risk injuring its reputation, if it suddenly altered the terms of the program. Also, Cadence has good reasons for having so many Connections partners—they offer Cadence customers valuable tools, most of which do not compete with Cadence products. It seems unlikely that Cadence would be motivated to make the Connections Program less appealing to those partners.

Both Commissioners Azcuenaga and Starek suggest that the remedy may be difficult to enforce. Any time this Commission enters an order, it takes upon itself the burden of enforcing the order, which requires use of our scarce resources. However, we think the order, which simply requires Cadence to allow competitors and potential competitors developing routing technology to participate in independent software interface programs on terms no less favorable than the terms applicable to any other participants in such programs, is a workable approach.[11] Connections partners all sign the same standard-form contract and there has been a consistent pattern of conduct with respect to the program to use as a baseline for future comparisons. Moreover, the Commission has had experience with such non-discrimination provisions, and can rely on respondent's compliance reports required under the order as well as complaints from independent software developers to ensure compliance with the consent order. We think the dissenting Commissioners' scenarios about intractable compliance issues are unfounded. . . .

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[11] The language of the consent order is clear in requiring that terms for routing companies be no less favorable than for any other participant in the Connections Program. Thus, we do not understand Commissioner Starek's conclusion that the order could be interpreted to require routing companies to pay a "fee no higher than the highest fee." . . .

■ **Statement of Commissioner Mary L. Azcuenaga Concurring in Part and Dissenting in Part.**

The acquisition of [CCT] by Cadence . . . combines the only firm currently marketing [an] integrated circuit routing tool with a firm that was, at least until the acquisition, on the verge of entry into this market. I find reason to believe that the proposed merger would violate Section 7 of the Clayton Act under a horizontal, potential competition theory [because Cadence was likely to enter the tool market, and thus I concur in the part of the order requiring notification of future acquisitions of tool companies.]. . . .

The vertical theory of violation alleged in the complaint is that the acquisition of [CCT] by Cadence will make it more difficult for another firm to introduce [an] IC router because such an entrant would need its own IC layout environment to enter the market, and that dual level entry is more difficult. Although this is a recognized theory, I question whether it applies in this case and whether a firm needs to enter both the routing and the environment markets simultaneously.

[CCT] was successful in developing and marketing its routing program before it gained access to Cadence's environment. In a separate statement, Chairman Pitofsky and Commissioners Varney and Steiger assert that [CCT's] "sales were modest before the merger announcement." I disagree based on [CCT's] penetration of the market. Cadence's willingness to pay more that $400 million in stock for [CCT] also suggests a greater competitive significance than the majority concedes. [CCT's] record indicates that access to a layout environment is not a precondition to successful entry in the market for . . . integrated circuit routers. It appears, based on the available information, that dual level entry theory does not apply in this market.

In addition, although Cadence initially denied [CCT] access to its connections program, it subsequently reversed course and granted the access. This suggests that Cadence capitulated to pressure from customers to grant [CCT] access and that Cadence has little or no power to deny access to its connections program if granting access is the only way to enable its customers to use a product they want to use. Finally, . . . the order is premised on the allegation in . . . the complaint that "Cadence does not, however, have incentives to provide access to a Cadence integrated circuit layout environment to suppliers of integrated circuit layout tools that compete with Cadence products." The incentives appear to be at least as likely to go the other way. If another company develops an innovative, advanced router, one would assume that Cadence would have incentives to welcome the innovative product to its suite of connected design tools, thereby enhancing the suite's utility to customers.

[T]he order [requiring equal access to interfaces] may be counterproductive and may result in substantial enforcement costs for the Commission. Because [this order] bars Cadence from charging developers of "Commercial Integrated Circuit Routing Tools" a higher access fee than developers of other design tools, one possible, unintended consequence of the order is that Cadence may reduce or eliminate discounting of access fees. In addition, enforcement of the provision of the order requiring Cadence to provide access to the connections program to developers of "Commercial Integrated Circuit Routing Tools" on terms "no less favorable than the terms applicable to any other participants" may embroil the Commission unnecessarily in complex commercial disputes. . . .

■ **Dissenting Statement of Commissioner Roscoe B. Starek, III**

. . . To justify the complaint and order, the Commission once again invokes the specter of anticompetitive "foreclosure" as a direct consequence of the transaction. As I have made clear on previous occasions, foreclosure theories are generally unconvincing as a rationale for antitrust enforcement. The current case provides scant basis for revising this conclusion. . . .

The logic of the complaint is fundamentally flawed. Even if we assume arguendo—as the complaint in this case does—that Cadence is "dominant" in the supply of software components

complementary to the router,[4] the fact remains that it has no incentive to restrict the supply of routers . . .[5] The same is true here: the introduction of a lower-priced or higher-quality routing program increases the value of Cadence's "dominant" position in the sale of software complementary to the router, because it increases the demand for Cadence design software, thereby allowing Cadence to increase the price and/or the output of these programs. Despite the assertions of Chairman Pitofsky and Commissioner Steiger to the contrary,[6] this is true whether or not Cadence has vertically integrated into the sale of routing software, for efficient entry into the production of routing software increases the joint profits of the entrant and Cadence. If the Commission is correct that Cadence is "dominant" in the supply of software components complementary to routers, then of course Cadence may be in a position to expropriate—e.g., via royalties paid to Cadence by the entrant for the right to "connect" to Cadence's software—some or all of the "efficiency rents" that otherwise would accrue to an efficient entrant. This, however, would constitute harm to a competitor, not to competition, and Cadence would have no incentive to set any such rates so high as to preclude entry. . . .

Contrary to the analysis presented above, suppose that somehow Cadence could profit anticompetitively from denying interconnection rights to independent router vendors. If that were so, then it would not be sufficient merely to prevent Cadence from acquiring producers of complementary software. Rather, the Commission would have to take the further step of preventing Cadence from developing its own routers; for under the anticompetitive theory advanced in the complaint, any vertical integration by Cadence into routers, whether accomplished by acquisition or through internal expansion, would engender equivalent post-integration incentives to "foreclosure" independent vendors of routing software.[8] Of course, . . . there is likely to be little enthusiasm for such a policy because there is a general predisposition to regard internal capacity expansion as procompetitive.[9]

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[4] The anticompetitive theory requires Cadence to have substantial monopoly power: if there were numerous good alternatives to Cadence's suite, other independent vendors of routing software could affiliate with them and there would be no "foreclosure."

[5] Moreover, . . . the description of the premerger state of competition set forth in the complaint itself tends to exclude the possibility of substantial postmerger foreclosure. . . . [T]he . . . complaint alleges that there are substantial premerger barriers to entry into the market for the kind of "router" software that CCT produces. But one cannot find both that the premerger supply elasticity of substitutable software is virtually zero and that the merger would result in the substantial postmerger foreclosure of independent software producers. If entry into . . . IC router software is effectively blocked premerger, as the complaint contends, it cannot also be the case that the merger would cause a substantial incremental reduction in entry opportunities.

[6] Chairman Pitofsky and Commissioner Steiger assert that "Cadence clearly also has an incentive to prevent loss of sales in its competing products." . . . Because [they never describe] . . . how this conclusion was reached, it is difficult to identify precisely the source of the erroneous reasoning. Chiefly, however, it seems to reflect a manifestation of the "sunk cost fallacy," whereby it is argued that because Cadence has now sunk a large sum of money into acquiring CCT, this in and of itself would provide Cadence with an incentive not to deal with independent vendors of complements. This reasoning, of course, is fallacious: the cost incurred by Cadence in acquiring CCT—whether a large or a small sum—is irrelevant to profit-maximizing behavior once incurred, for bygones are forever bygones. The introduction of a superior new router, even if by an independent vendor, will increase the joint profits of Cadence and this vendor (irrespective of the amount spent in acquiring CCT), and both parties will have a profit incentive to facilitate its introduction.

[8] Thus, it is unclear how the Commission should respond, under the logic of its complaint, were Cadence to introduce an internally developed software program (now provided by one or more independent vendors) that is complementary to its "dominant" suite of programs. Obviously Cadence would be in a position (similar to that alleged in the Commission's complaint) to block access to the Cadence design software if it wanted to. Even if Cadence did not terminate the independent vendors, consistent application of the economic logic of the present complaint seemingly would require the Commission to seek a prophylactic "open access" order against Cadence similar to the order sought here. This enforcement policy would of course have a number of adverse competitive consequences, including deterrence of Cadence from efficiently entering complementary software lines through internal expansion.

[9] . . . [T]he Commission has alleged the existence of substantial pre-acquisition market power in both vertically related matters (routing software and the rest of the IC layout "suite" . . .). Under these circumstances, there is a straightforward reason why vertical integration is both profitable and procompetitive (i.e., likely to result in lower prices to consumers): vertical

Not only am I unpersuaded that Cadence's acquisition of CCT is likely to reduce competition in any relevant market, but . . . I would find the order unacceptable even were I convinced as to liability. . . . [T]he Commission imposes a "most favored nations" clause that requires Cadence to allow all independent router developers to participate in its software interface programs on terms that are "no less favorable than the terms applicable to any other participants in" those interface programs. Even apart from the usual problems with "most favored nations" clauses in consent orders,[10] this order . . . will require that the Commission continuously regulate the prices and other conditions of access.

. . . What does it mean to mandate treatment "no less favorable than" that granted to others, when Cadence's current Connections Program—with well over 100 participants—allows access prices to differ substantially across participants and imposes substantial restrictions on the breadth and scope of the permitted connection rights?[11] Does it mean that router vendors pay a connection fee no higher than the highest fee paid by an existing participant? Or would they pay a fee no higher than the current lowest fee? Or does it mean something else? Router vendors surely will argue for the second interpretation—a view also apparently shared by Chairman Pitofsky and Commissioner Steiger—yet there is no obvious reason why router vendors should be entitled to such a Commission-mandated preferential pricing arrangement . . . Similarly, does the "no less favorable" requirement mandate that the vendors of routing software obtain access rights as broad as the broadest rights now granted, or simply no worse than the narrowest now granted? . . .

The preceding suggests strongly that the real (albeit unstated) goal of the order is not to nullify any actual anticompetitive effects from the transaction, but rather to invalidate the principal aspects of Cadence's "Connections Program" (i.e., the ability to charge different connection fees and to terminate vendors at will) without demonstrating that the program's provisions violate the law. There is little reason to believe that this program is harmful to competition, and there are strong efficiency reasons for allowing Cadence to set different fees for different vendors. Moreover, setting a uniform fee would result in price increases to at least some vendors.

Because I do not accept the Commission's theory of liability in this case, and because I find the prescribed remedy at best unenforceable and at worst competitively harmful, I dissent.

NOTES AND QUESTIONS ON *CADENCE*

The proposed vertical merger was between Cadence, which was the dominant supplier of integrated circuit (IC) layouts, and CCT, which was the only firm with a commercially viable IC routing tool. IC tools, including IC routing tools, required an interface with a compatible IC layout. The anticompetitive concern was that the merged firm would deny Cadence IC layout interfaces to future entrants into the IC routing tool market, which would raise the barriers for entering the IC routing tool market by requiring entrants to also enter the IC layout market. The consent decree approved the merger on the condition that the merged firm allow other IC routing tool companies equal access to Cadence's Connections Program, which provided interfaces necessary to work with the Cadence layout to 100 other makers of IC tools.

1. Was anticompetitive market foreclosure possible? Two doubts were raised about the possibility of foreclosure. First, even if the merger foreclosed routing tool entrants from Cadence's

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integration would yield only one monopoly markup by the integrated firm, rather than separate markups (as in the pre-integration situation) by Cadence and CCT.

[10] . . . [T]hese clauses have the capacity to cause all prices to rise rather than to fall. The Chairman and Commissioner Steiger seem comfortable with this outcome, provided that all vendors pay the same price.

[11] For example, CCT had been permitted to participate in the Connections Program with its printed circuit board router but not with its IC router.

layouts, entrants could try to persuade IC designers to use layouts from Avant!, the other firm in the layout market. However, Cadence was dominant in the layout market, which means that its layout must have had some significant advantages over other layouts and that IC designers would generally use Cadence layouts. Being foreclosed from access to the dominant layout would thus discourage entry into the IC routing tool market, even if entrants could still sell routing tools to IC designers willing to use other layouts. Moreover, Avant! had been criminally charged for stealing trade secrets from Cadence, which indicated Avant! might (if the case went badly for it) not be able to supply layouts at all.

Second, Commissioner Azcuenaga argued that a routing tool company must not really need a Cadence layout interface because CCT itself successfully entered the routing tool market without one. However, the majority observed that CCT was unable to make significant sales until Cadence authorized an interface to its IC layout.

2. Would the merged firm have incentives to foreclose? Commissioner Starek's dissent argued that the merged firm would have no incentive to deny access to its layout to rival producers of routing tools. If such foreclosure would not increase entry barriers (by requiring rivals to enter both markets to offer a desirable combination of layouts and routing tools), then he would be correct that Cadence's economic incentives would be to maximize the value of its layout by having the most efficient router tools in the market.[17] However, if foreclosure would increase entry barriers in this way, then denying access to the merged firm's layouts could increase the degree of market power that the merged firm would have in either or both markets, which would increase its profits and thus give it an incentive to deny access to its layout.

Perhaps Commissioner Starek ignores the possibility that foreclosure might raise entry barriers because his footnote 5 assumes that the existence of entry barriers to the routing tool market means that the merger cannot increase entry barriers. He would be correct on that point if entry barriers to the routing tool market were infinite, because requiring two-level entry cannot increase entry barriers if they are already infinite. But if entry barriers to routing tools are high but not infinite, then those entry barriers could be raised by requiring two-level entry.

However, even if denying access to layouts would increase entry barriers, the result would be conflicting economic incentives: an incentive to increase entry barriers and a contrary incentive to have the most efficient complementary product. Predicting post-merger foreclosure means concluding that the former incentive will likely outweigh the latter, which can be difficult to determine. Here, the FTC majority concluded that the entry-barrier-increasing incentive would likely win out because in the past Cadence had historically denied IC layout access to suppliers of competing IC tools, even though the efficient-complementary-product incentive did cause Cadence to grant access to suppliers of noncompetitive IC tools.

3. Might eliminating successive market power be efficient? Starek dissent footnote 9 points out that the existence of market power in both the layout and routing tool markets suggests that the merger would eliminate successive market power and thus increase efficiency. *See* Chapter 3.C.5. This is probably the best argument for Starek's position. Further, such successive market power seems likely to exist for most vertical mergers that are potentially anticompetitive, given that such anticompetitive concerns generally require market power at both levels.

On the other hand, successive market power need not always create a double marginalization problem. Pre-merger, the upstream firm might engage in two-part pricing, charging a lump sum for the right to buy the product and pricing subsequent units at marginal cost or (if the upstream firm does not have an absolute monopoly) the downstream firm might be purchasing from a rival of the

[17] See Chapter 3.C.5 on refusals to deal. This analysis assumes router tools are useless without layouts and that router tools and layouts are used in a fixed ratio. If routing tools have separate utility or if layouts and routing tools are used in varying proportions, then the other anticompetitive effects from tying could apply and make it profitable to tie layouts and routing tools by denying layout access to rival routing tools. See Chapter 4.C on tying.

upstream firm that lacks market power. Vertical maximum price fixing might either eliminate double-marginalization already or be a less restrictive alternative to a vertical merger for eliminating it. *See* Chapters 3.C.5, 5.B.2. Another less restrictive alternative could be merging with a commitment not to discriminate among IC tools that want layout access, as was provided in the consent decree remedy. That would achieve the procompetitive efficiency of eliminating the successive monopolies problem, while prohibiting a post-merger foreclosure that could lead to the anticompetitive effect of raising entry barriers by requiring two-level entry. Finally, even if there were no less restrictive alternative for obtaining the efficiency gain from eliminating the successive monopolies problem, that efficiency gain could be quantified in a way that might indicate it was too small to offset the anticompetitive effects from the merger.

4. Do the reasons to restrict vertical mergers also apply to vertical expansion? The Starek dissent argues that the theory applied to this merger must be wrong because it implies the FTC should also ban internal expansion into vertical markets, which is generally deemed procompetitive. He is right that vertical expansion could create similar anticompetitive incentives to foreclose rivals. However, unlike vertical mergers (which simply acquire existing firms), internal expansion adds new capacity and output, which is more likely to benefit consumer welfare. Also, legally, Clayton Act § 7 applies to acquisitions, not to internal expansions.

5. Why not allow the merger and police any anticompetitive post-merger foreclosure under the unilateral refusal to deal doctrine? That would be an alternative. Indeed, if any post-merger refusal to deal involved discrimination based on rivalry, such as denying layout interface access to competing tools but not to noncompeting tools, it would seem to violate the refusal to deal doctrine if it created or enhanced monopoly power and lacked any persuasive efficiency justification. *See* Chapter 3.C.5. But the refusal to deal doctrine has been narrowly construed, is often uncertain, and requires significant costly litigation. The equal access condition for merger approval effectively provided a nondiscrimination duty that was more easily enforceable because it did not require proving any enhancement of monopoly power or lack of efficiencies. Such a nondiscrimination duty is easier to enforce than an absolute duty to deal because the terms of the required dealing can be ascertained by seeing how the Connections Program treats noncompeting tools.

If the refusal to deal doctrine has already been optimized to deal with this issue, is it justifiable to impose a broader nondiscrimination duty as a condition of approving a vertical merger? Perhaps. The refusal to deal doctrine allows a lot of underdeterrence of anticompetitive refusals to deal because of worries that the alternative would overdeter investments in creating valuable facilities. For vertical mergers, the overdeterrence concerns are smaller, given that the valuable facilities already exist and the merger is just creating new incentives to anticompetitively deny access to those facilities, so it makes sense to focus more on the serious underdeterrence concerns.

United States v. AT&T, Inc.

916 F.3d 1029 (2019).

■ Rogers, Circuit Judge:

On October 22, 2016, AT&T Inc. announced a proposed merger with Time Warner Inc. The government sued to enjoin this vertical merger under Section 7 of the Clayton Act, 15 U.S.C. § 18, and now appeals the denial of its request for a permanent injunction. Although it pursued three theories of antitrust violation in the district court, the government on appeal challenges only the district court's findings on its increased leverage theory whereby costs for Turner Broadcasting System's content would increase after the merger, principally through threats of long-term "blackouts" during affiliate negotiations….

I.

… Neither the government nor the defendants challenge application of the burden-shifting framework in *United States v. Baker Hughes*, 908 F.2d 981, 982–83 (D.C. Cir. 1990), for horizontal mergers that the district court applied to consider the effect of the proposed vertical merger of AT&T and Time Warner on competition. Under this framework, the government must first establish a *prima facie* case that the merger is likely to substantially lessen competition in the relevant market. *United States v. Anthem*, 855 F.3d 345, 349 (D.C. Cir. 2017). But unlike horizontal mergers, the government cannot use a short cut to establish a presumption of anticompetitive effect through statistics about the change in market concentration, because vertical mergers produce no immediate change in the relevant market share. *See* Dept. of Justice & Fed. Trade Comm'n, Non-Horizontal Merger Guidelines § 4.0 (June 14, 1984) ("1984 Non-Horizontal Merger Guidelines"). Instead, the government must make a "fact-specific" showing that the proposed merger is "likely to be anticompetitive." Joint Statement on the Burden of Proof at Trial at 3–4. Once the *prima facie* case is established, the burden shifts to the defendant to present evidence that the *prima facie* case "inaccurately predicts the relevant transaction's probable effect on future competition," *Anthem*, 855 F.3d at 349 (quoting *Baker Hughes*, 908 F.2d at 991), or to "sufficiently discredit" the evidence underlying the *prima facie* case, *id.* Upon such rebuttal, "the burden of producing additional evidence of anticompetitive effects shifts to the government, and merges with the ultimate burden of persuasion, which remains with the government at all times." *Baker Hughes*, 908 F.2d at 983.

The relevant market definition is also undisputed by the government and the defendants…. The district court accepted the government's proposal that the product market is the market for multichannel video distribution. Although this market definition excludes distributors of only on-demand content, such as Netflix and Hulu, the district court considered the impact of the increasing presence of these distributors on the multichannel video programming and distribution industry. The district court also accepted the government's proposed geographic market, which included over 1,100 local multichannel video distribution markets. The government did not rely on any particular market for enjoining the proposed merger; one of its experts aggregated the alleged harms in the local markets to derive a total measure of nationwide economic harm.

As the government has presented its challenges to the district court's denial of a permanent injunction, the question for this court is whether the district court's factual findings are clearly erroneous…. The government contends that it has made the requisite showing of error because the district court's conclusion it had failed to meet its burden of proof "rests on two fundamental errors: the district court discarded the economics of bargaining, and the district court failed to apply the foundational principle of corporate-wide profit maximization." Appellant Br. 29, 37–38. Further, the government contends that the district court used internally inconsistent logic when evaluating industry evidence and clearly erred in rejecting its expert's quantitative model of harm…

II.

A.

The video programming and distribution industry traditionally operates in a three-stage chain of production. Studios or networks create content. Then, programmers package content into networks and license those networks to video distributors. Finally, distributors sell bundles of networks to subscribers. For example, a studio may create a television show and sell it to Turner Broadcasting System ("Turner Broadcasting"), a programmer, which would package that television show into one of its networks, such as CNN or TNT. Turner Broadcasting would then license its networks to distributors, such as DirecTV or Comcast.

Programmers license their content to distributors through affiliate agreements, and distributors pay "affiliate fees" to programmers. Programmers and distributors engage in what are oftentimes referred to as "affiliate negotiations," which, according to evidence before the

district court, can be lengthy and complicated. If a programmer and a distributor fail to reach an agreement, then the distributor will lose the rights to display the programmer's content to its customers. This situation, known as a "blackout" or "going dark," is generally costly for both the programmer, which loses affiliate fee revenues, and the distributor, which risks losing subscribers. Therefore, blackouts rarely occur, and long-term blackouts are especially rare. The evidence indicated, however, that programmers and distributors often threaten blackouts as a negotiating tactic, and both may perform "go dark" analyses to estimate the potential impact of a blackout in preparation for negotiations.

The evidence before the district court also showed that the industry has been changing in recent years. Multichannel video programming distributors ("MVPDs") offer live television content as well as libraries of licensed content "on demand" to subscribers. So-called "traditional" MVPDs distribute channels to subscribers on cable or by satellite. Recently, "virtual" MVPDs have also emerged. They distribute live videos and on-demand videos to subscribers over the internet and compete with traditional MVPDs for subscribers. Virtual MVPDs, such as DirecTV Now and YouTube TV, have been gaining market share, the evidence showed, because they are easy to use and low-cost, often because they offer subscribers smaller packages of channels, known as "skinny bundles."

In addition, subscription video on demand services ("SVODs") have also emerged on the market. SVODs, such as Netflix, do not offer live video content but have large libraries of content that a viewer may access on demand. SVODs also offer low-cost subscription plans and have been gaining market share recently. Increasingly, cable customers are "cutting the cord" and terminating MVPD service altogether. Often these customers do not exit the entertainment field altogether, but instead switch to SVODs for entertainment service.

Leading SVODs are vertically integrated, which means they create content and also distribute it. Traditional MVPDs typically are not vertically integrated with programmers. In 2009, however, Comcast Corporation ("Comcast") (a distributor and the largest cable company in the United States) announced a $30 billion merger with NBC Universal, Inc. ("NBCU") (a content creator and programmer), whereby it would control popular video programming that included the NBC broadcast network and the cable networks of NBC Universal, Inc. The government sued to permanently enjoin the merger under Section 7, alleging that Comcast's "majority control of highly valued video programming ... would prevent rival video-distribution companies from competing against the post-merger entity." *United States v. Comcast*, 808 F.Supp.2d 145, 147 (D.D.C. 2011). The district court, with the defendants' agreement and at the government's urging, allowed the merger to proceed subject to certain remedies for the alleged anticompetitive conduct post-merger, including remedies ordered in a related proceeding before the Federal Communications Commission ("FCC"). *Id.* One remedy in the Comcast-NBCU merger was an agreement by the defendants to submit, at a distributor's option, to "baseball style" arbitration — in which each side makes a final offer and the arbitrator chooses between them — if parties did not reach a renewal agreement. During the arbitration, the distributor would retain access to NBC content, thereby mitigating concerns that Comcast-NBCU may withhold NBC programming during negotiations in order to benefit Comcast's distribution subscriptions. Comcast-NBCU currently operates as a "vertically integrated" programmer and distributor.

Now the government has again sued to halt a proposed vertical merger of a programmer and a distributor in the same industry. On October 22, 2016, AT&T Inc. announced its plan to acquire Time Warner Inc. ("Time Warner") as part of a $108 billion transaction. AT&T Inc. is a distribution company with two traditional MVPD products: DirecTV and U-verse. DirecTV transmits programming over satellite, while U-verse transmits programming over cable. Time Warner, by contrast, is a content creator and programmer and has three units: Warner Bros., Turner Broadcasting, and Home Box Office Programming ("HBO"). Warner Bros. creates movies, television shows, and other video programs. Turner Broadcasting packages content into various

networks, such as TNT, TBS, and CNN, and licenses its networks to third-party MVPDs. HBO is a "premium" network that provides on-demand content to subscribers either directly through HBO Now or through licenses with third-party distributors. The merged firm would operate both AT&T MVPDs (DirecTV and U-verse) and Turner Broadcasting networks (which license to other MVPDs). The government alleged that "the newly combined firm likely would ... use its control of Time Warner's popular programming as a weapon to harm competition."

A week after the government filed suit to stop the proposed merger, Turner Broadcasting sent letters to approximately 1,000 distributors "irrevocably offering" to engage in "baseball style" arbitration at any time within a seven-year period, subject to certain conditions not relevant here. According to President of Turner Content Distribution Richard Warren, the offer of arbitration agreements was designed to "address the government's concern that as a result of being ... commonly owned by AT&T, [Turner Broadcasting] would have an incentive to drive prices higher and go dark with [its] affiliates," Tr. 1182 (April 3, 2018). In the event of a failure to agree on renewal terms, Turner Broadcasting agreed that the distributor would have the right to continue carrying Turner networks pending arbitration, subject to the same terms and conditions in the distributor's existing contract.

B.

The government's increased leverage theory is that "by combining Time Warner's programming and DirecTV's distribution, the merger would give Time Warner increased bargaining leverage in negotiations with rival distributors, leading to higher, supracompetitive prices for millions of consumers." Appellant Br. 33. Under this theory, Turner Broadcasting's bargaining position in affiliate negotiations will change after the merger due to its relationship with AT&T because the cost of a blackout will be lower. Prior to the merger, if Turner Broadcasting failed to reach a deal with a distributor and engaged in a long-term blackout, then it would lose affiliate fees and advertising revenues. After the merger, some costs of a blackout would be offset because some customers would leave the rival distributor due to Turner Broadcasting's blackout and a portion of those customers would switch to AT&T distributor services. The merged AT&T-Turner Broadcasting entity would earn a profit margin on these new customers. Because Turner Broadcasting would make a profit from switched customers, the cost of a long-term blackout would decrease after the merger and thereby give it increased bargaining leverage during affiliate negotiations with rival distributors sufficient to enable it to secure higher affiliate fees from distributors, which would result in higher prices for consumers.

To support this theory of competitive harm, the government presented evidence purporting to show the real-world effect of the proposed merger. Specifically, it introduced statements in prior FCC filings by AT&T and DirecTV that vertical integration provides an incentive to increase prices and poses a threat to competition. Various internal documents of the defendants were to the same effect. Third-party competitors, such as cable distributors, testified that the merger would increase Turner Broadcasting's bargaining leverage.

The government also presented the expert opinion of Professor Carl Shapiro on the likely anticompetitive effect of the proposed merger. He opined, based on the economic theory of bargaining — here, the Nash bargaining theory — that Turner Broadcasting's bargaining leverage would increase after the merger because the cost of a long-term blackout would decrease. His quantitative model predicted net price increases to consumers. Specifically, his model predicted increases in fees paid by rival distributors for Turner Broadcasting content and cost savings for AT&T through elimination of double marginalization ("EDM"). The fee increases for rival distributors were based on the expected benefit to AT&T of a Turner Broadcasting blackout after the merger. Professor Shapiro determined the extent to which rival distributors and AT&T would pass on their respective cost increases and cost decreases to consumers. His model predicted: (1) an annual fee increase of $587 million for rival distributors to license Turner

Broadcasting content, and cost savings of $352 million for AT&T; and (2) an annual net increase of $286 million in costs passed on to consumers in 2016, with increases in future years.

AT&T responded by pointing to testimony of executives' past experience in affiliate negotiations, and presenting testimony by its experts critiquing Professor Shapiro's opinion and model. It purported to show through its own experts that the government's *prima facie* case inaccurately predicted the proposed merger's probable effect on competition. Professor Dennis Carlton's econometric analysis … showed that prior instances of vertical integration in the MVPD market had not had a "statistically significant effect on content prices," pointing to data on the Comcast-NBCU merger in 2011 as well as prior vertical integration between News Corp.-DirecTV and Time Warner Cable-Time Warner Inc., which split in 2008 and 2009, respectively. Professor Carlton and Professor Peter Rossi critiqued the "inputs" used by Professor Shapiro in his quantitative model, opining for instance that values he used for subscriber loss rate and diversion rate were not calculated through reliable methods. Professor Carlton also opined that Professor Shapiro's quantitative model overestimated how quickly harm would occur because it failed to consider existing long-term contracts.

Professor Shapiro, in turn, critiqued Professor Carlton's econometric analysis as comparing different types of vertical mergers. Regarding the "inputs" to his quantitative model, Professor Shapiro conceded that he was unaware the subscriber loss rate percentage he used (from a consultant report for Charter Communications, Inc.) had been changed after the report was presented to Charter executives. He also acknowledged that he had not considered the effects of the arbitration agreements offered by Turner Broadcasting and that to do so would require preparation of a new model….

The district court found that the government had "failed to clear the first hurdle of showing that the proposed merger is likely to increase Turner [Broadcasting]'s bargaining leverage in affiliate negotiations." Although acknowledging, as Professor Shapiro had opined, that the Nash bargaining theory could apply in the context of affiliate fee negotiations, the district court found more probative the real-world evidence offered by AT&T than that offered by the government. The econometric analysis of AT&T's expert had examined real-world data from prior instances of vertical integration in the video programming and distribution industry and concluded that "the bulk of the results show no significant results at all, but many do show a decrease in content prices." The district court also credited the testimony of several industry executives — *e.g.*, Madison Bond, lead negotiator for NBCU, and Coleman Breland and Richard Warren, lead negotiators for Turner Broadcasting — that vertical integration had not affected their affiliate negotiations in the past. By contrast, the testimony from third-party competitors that the merger would increase Turner Broadcasting's bargaining leverage was, the district court found, "speculative, based on unproven assumptions, or unsupported." Although Professor Shapiro's opinion was that the Nash bargaining theory predicted an increase in Turner Broadcasting's post-merger bargaining leverage, leading to an increase in affiliate fees, the district court found, in view of the industry's dynamism in recent years, that Professor Shapiro's opinion (by contrast with Professor Carlton's) had "not been supported by sufficient real-world evidence."

Second, the district court found that Professor Shapiro's quantitative model, which estimated the proposed merger would result in future increases in consumer prices, lacked sufficient reliability and factual credibility to generate probative predictions of future competitive harm. Relying on critiques by Professor Carlton and Professor Rossi, the district court found errors in the model "inputs," for example, the value used for subscriber loss rate was not calculated through a reliable method. Neither the model nor Professor Shapiro's opinion accounted for the effect of the irrevocably-offered arbitration agreements, which the district court stated would have "real world effects" on negotiations and characterized "as extra icing on a cake already frosted," another reason the government had not met its first-level burden of proof.

The district court therefore concluded that the government failed to present persuasive evidence that Turner Broadcasting's bargaining leverage would "materially increase" as a result of the merger, or that the merger would lead to "*any* raised costs" for rival distributors or consumers. It therefore did not address the balancing analysis offered by Professor Shapiro's quantitative model, nor the question whether any increased costs would result in a substantial lessening of competition.

III.

On appeal, the government contends that the district court court (1) misapplied economic principles, (2) used internally inconsistent logic when evaluating industry evidence, and (3) clearly erred in rejecting Professor Shapiro's quantitative model. Undoubtedly the district court made some problematic statements, which the government identifies and this court cannot ignore. And in the probabilistic Section 7 world, uncertainty exists about the future real-world impact of the proposed merger on Turner Broadcasting's post-merger leverage. At this point, however, the issue is whether the district court clearly erred in finding that the government failed to clear the first hurdle in meeting its burden of showing that the proposed merger is likely to increase Turner Broadcasting's bargaining leverage.

(1) Application of economic principles. The government contends that in evaluating the evidence in support of its increased leverage theory, the district court erroneously discarded or otherwise misapplied two economic principles — the Nash bargaining theory and corporate-wide profit maximization.

(a) Nash bargaining theory. The Nash bargaining theory is used to analyze two-party bargaining situations, specifically where both parties are ultimately better off by reaching an agreement. John F. Nash, Jr., *The Bargaining Problem*, 18 *Econometrica* 155 (1950). The theory posits that an important factor affecting the ultimate agreement is each party's relative loss in the event the parties fail to agree: when a party would have a greater loss from failing to reach an agreement, the other party has increased bargaining leverage. In other words, the relative loss for each party affects bargaining leverage and when a party has more bargaining leverage, that party is more likely to achieve a favorable price in the negotiation.

The district court had to determine whether the economic theory applied to the particular market by considering evidence about the "structure, history, and probable future" of the video programming and distribution industry. *United States v. General Dynamics*, 415 U.S. 486, 498 (1974) (internal quotation marks omitted); *see also Brown Shoe*, 370 U.S. at 321–22 & n.38. As one circuit has put it, "[t]he Nash theorem arrives at a result that follows from a certain set of premises," while the theory "asserts nothing about what situations in the real world fit those premises." *VirnetX, Inc., v. Cisco Sys. Inc.*, 767 F.3d 1308, 1332 (Fed. Cir. 2014). The district court concluded that the government presented insufficient real-world evidence to support the prediction under the Nash bargaining theory of a material increase of Turner Broadcasting's post-merger bargaining leverage in affiliate negotiations by reason of less-costly long-term blackouts. The government's real-world evidence consisted of statements by AT&T Inc. and DirecTV in FCC regulatory filings that vertical integration, such as in the proposed Comcast-NBCU merger, can give distributors an incentive to charge higher affiliate fees and expert opinion and a quantitative model prepared by Professor Shapiro. The expert opinion and model were subject to deficiencies identified by AT&T's experts, some of which Professor Shapiro conceded. By contrast, AT&T's expert's econometric analysis of real-world data showed that content pricing in prior vertical mergers in the industry had not increased as the Nash bargaining theory and the model predicted. Given evidence the industry was now "remarkably dynamic," the district court credited CEO testimony about the null effect of vertical integration on affiliate negotiations.

In other words, the record shows that the district court accepted the Nash bargaining theory as an economic principle generally but rejected its specific prediction in light of the evidence that the district court credited….

More concerning is the government's contention that the district court misapplied the Nash bargaining theory in a manner that negated its acceptance of the economics of bargaining by erroneously focusing on whether long-term blackouts would actually occur after the merger, rather than on the changes in stakes of such a blackout for Turner Broadcasting. The government points to the district court's statements that Professor Shapiro's testimony was undermined by evidence that "a blackout would be infeasible." The district court also stated that "there has never been, and is likely never going to be, an actual long-term blackout of Turner [Broadcasting] content." The district court noted that "Turner [Broadcasting] would *not be willing* to accept the 'catastrophic' affiliate fee and advertising losses associated with a long-term blackout."

The question posed by the Nash bargaining theory is whether Turner Broadcasting would be more favorably positioned after the merger to assert its leverage in affiliate negotiations whereby the cost of its content would increase. Considered in isolation, the district court's statements could be viewed as addressing the wrong question. Considered as part of the district court's analysis of whether the stakes for Turner Broadcasting would change and if so by how much, the statements address whether the threat of long-term blackouts would be credible, as posited by the government's increased leverage theory. The district court found that after the merger the stakes for Turner Broadcasting would change only slightly, so its threat of a long-term blackout "will only be somewhat less incredible." Recognizing Professor Shapiro applied the Nash bargaining theory in opining that "if a party's alternative to striking a deal improves, that party is more willing and able to push harder for a better deal because it faces less downside risk if the deal implodes," the district court rejected the assumption underlying the government's theory that Turner Broadcasting would gain increased leverage from this slight change in stakes. It relied on testimony that the small change in bargaining position from a less costly blackout would not cause Turner Broadcasting to take more risks, specifically noting the Time Warner CEO's analogy of the cost difference between having a 1,000-pound weight fall on Turner Broadcasting and a 950-pound weight fall on it — the difference being unlikely to change the risk Turner Broadcasting would be willing to take.

…. In finding the government failed to "prov[e] that Turner [Broadcasting]'s post-merger negotiating position would materially increase based on its ownership by AT&T," the district court reached a fact-specific conclusion based on real-world evidence that, contrary to the Nash bargaining theory and government expert opinion on increased content costs, the post-merger cost of a long-term blackout would not sufficiently change to enable Turner Broadcasting to secure higher affiliate fees. Witnesses such as a Turner Broadcasting president Coleman Breland, AT&T executive John Stankey, and Time Warner CEO Jeff Bewkes, whom the district court credited, testified that after the merger blackouts would remain too costly to risk and that any change in that cost would not affect negotiations as the government's theory predicted.

Not to be overlooked, the district court also credited the efficacy of Turner Broadcasting's "irrevocable" offer of arbitration agreements with a no-blackout guarantee. It characterized the no-blackout agreements as "extra icing on a cake already frosted." In crediting Professor Carlton's econometric analysis, the district court explained that it was appropriate to consider the analysis of the Comcast-NBCU merger because the Comcast-NBCU merger was similar to the proposed merger — a vertical merger in the video programming and distribution industry. There the government had recognized, "'especially in vertical mergers, that conduct remedies,' such as the ones proposed [in the *Comcast* case], 'can be a very useful tool to address the competitive problems while preserving competition and allowing efficiencies' that 'may result from the transaction.'"…

The post-merger arbitration agreements would prevent the blackout of Turner Broadcasting content while arbitration is pending…. Consequently, the government's challenges to the district court's treatment of its economic theories becomes largely irrelevant, at least during the seven-year period….

Further, the government's contention that the district court failed to properly weigh the probative force of the defendants' statements in FCC filings is unavailing. During licensing and rulemaking proceedings before the FCC, DirecTV stated "a standard economic model" (*i.e.*, the Nash bargaining theory) predicts that the proposed Comcast-NBCU merger "would significantly increase the prices other MVPDs pay for NBCU programming," and two years later stated, similar to AT&T Inc. comments, that "vertically integrated MVPDs have an incentive to charge higher license fees for programming that is particularly effective in gaining MVPD subscribers than do non-vertically integrated MVPDs." The district court took judicial notice of these statements pursuant to Federal Rule of Evidence 201, explaining it was "hesitant" to assign significant evidentiary value to the prior regulatory filings because AT&T and DirecTV made the statements acting as competitors whose positions would be affected by FCC review…. The statements were admissible as party admissions pursuant to Federal Rule of Evidence 801(d)(2), yet even as admissions, the district court had to evaluate their persuasive force in the circumstances before it, and the district court did.

The district court accepted the FCC statements as probative of the proposition that the Nash bargaining theory could apply in the context of affiliate fee negotiations. But it concluded generic statements that vertical integration "can" allow an entity to gain an unfair advantage over rivals were "informed by the state of the market at the time ... and the particular inputs to the models presented to the FCC." As such the FCC statements were "not particularly probative of whether [the proposed merger] could do the same with its programming in today's more competitive marketplace," with the rising presence of virtual MVPDs and SVODs, like Netflix and Hulu…. Once the district court credited AT&T's expert's opinion based on an econometric analysis that the similar Comcast-NBCU merger had not had a "statistically significant effect on content costs," the district court could understand that the defendants' admissions at the time of the Comcast-NBCU merger offered little probative support for the government's increased leverage theory.

Thus, even viewing the statements to the FCC as supportive of the government, the district court's finding of the efficacy of Turner Broadcasting's irrevocable offers of no-blackout arbitration agreements means the merger is unlikely to afford Turner Broadcasting increased bargaining leverage.

<u>(b) Corporate-wide profit maximization.</u> Still, the government maintains that the reliance on past negotiation experience indicates that the district court misunderstood, and failed to apply, the principle of corporate-wide profit maximization by treating the principle as a question of fact, when "[t]he assumption of profit maximization is 'crucial' in predicting business behavior." This principle posits that a business with multiple divisions will seek to maximize its total profits. It was adopted as a principle of antitrust law in *Copperweld*, holding that a parent and a wholly-owned subsidiary are not capable of conspiracy against each other under Section 1 of the Sherman Antitrust Act. Companies with multiple divisions must be viewed as a single actor, and each division will act to pursue the common interests of the whole corporation. *See id.* .

The district court never cited *Copperweld* in its opinion, which is troubling given the government's competitive harm theories and expert evidence based on economic principles. But the government's position that the district court never accepted this economic principle overlooks that it did "accept Professor Shapiro's (and the Government's) argument that generally, 'a firm with multiple divisions will act to maximize profits across them.' " And it ignores that if the merged firm was unable to exert the leverage required by the government's increased leverage theory, then inquiring (as the district court did of Professor Shapiro) about an independent basis to conclude that the firm did have such leverage is not a rejection of the corporate-wide profit maximization principle.

The government maintains that the district court's misapplication of the principle of corporate-wide profit maximization is evident from its statement the evidence suggests "vertically integrated corporations have previously determined that the best way to increase company wide

profits is for the programming and distribution components to separately maximize their respective revenues." Stating that the programming and distribution divisions would "separately maximize their respective revenues" is contrary to the maximization principle to the extent separate units would act against the merged entity's common interest. *See Copperweld*. At this point in its opinion, however, the district court was explaining why "that profit-maximization principle is *not* inconsistent with testimony that the identity of a programmer's owner has not affected affiliate negotiations in real-world instances of vertical integration." The district court can be viewed as conveying its understanding that Turner Broadcasting's interest in spreading its content among distributors, not imposing long-term blackouts, would redound to the merged firm's financial benefit, not that Turner Broadcasting would act in a manner contrary to the merged firm's financial benefit. Industry executives testified that "the identity of a programmer's owner has not affected affiliate negotiations in real-world instances of vertical integration," For instance, the Chair of Content Distribution at NBC Universal testified that at Comcast-NBCU, he "never once took into account the interest of Comcast cable in trying to negotiate a carriage agreement" for NBC Universal.

To the extent the government maintains this testimony is irreconcilable with the legal principle of corporate-wide profit maximization, it gives no credence to the district court's focus on "the best way to increase company wide profits," referring to the merged firm. In other words, the district court was explaining that real-world evidence reflected the profit-maximization principle. Even if the district court could have made clearer that it understood the principle was not a question of fact, the government does not explain how considering how that is done in a particular industry is contrary to the principle of corporate-wide profit maximization.

Nor is the conclusion that the merged firm would not be able to maximize its profits by raising prices during negotiations inconsistent with the principle of corporate-wide profit maximization. Based on the record evidence, the district court could plausibly understand that the proposed merger would not enable the merged entity to exert increased bargaining leverage by means of long-term blackouts and, therefore, would not affect affiliate fee negotiations to raise content costs. Finding the distributor division's interest would not affect Turner Broadcasting's negotiations with other distributors is consistent with the evidence that when a programmer and distributor merge, it is still in the best interests of the merged entity as a profit maximizer to license programming broadly to other distributors. That is, instead of withholding content in an attempt to benefit the merged entity, programmers will seek to license their content to other distributors. In this instance, the district court concluded the principle and the real world "fit." Moreover, AT&T's view that the government's claims of fundamental economic errors are ultimately irrelevant in light of Turner Broadcasting's irrevocable arbitration/no blackout commitment is not implausible….

<u>(2) Inconsistent reasoning in evaluating trial testimony.</u> The government further maintains that the district court used internally inconsistent reasoning when evaluating testimony from witnesses in the industry.

At trial, third-party distributors and executives from Comcast-NBCU and Time Warner testified about negotiations in the video programming and distribution industry. Third-party distributors testified about their concerns, and their reasons, that Turner Broadcasting would gain increased bargaining leverage as a result of the proposed merger. Comcast-NBCU and Time Warner executives testified that the interests of an affiliated distributor did not affect negotiations in their prior experiences negotiating on behalf of vertically integrated companies. The district court concluded that the third-party distributor testimony "fail[ed] to provide meaningful, reliable support for the [g]overnment's increased leverage theory," while the executives' testimony "undermine[d] the persuasiveness of the [g]overnment's proof." The district court declined to credit the third-party distributors' testimony because "there is a threat that [third-party distributor] testimony reflects self-interest," yet dismissed the suggestion that

testimony from the Time Warner executives should be discounted as potentially biased due to self-interest.

The government contends this reasoning was inconsistent because self-interest existed on both sides of the issue of whether the proposed merger would have anticompetitive effects. Even so, the potential for self-interest was not the only reason the district court found third-party distributor testimony of little probative value. Much of the third-party competitor testimony, the district court found, "consisted of speculative concerns," and did not contain any analysis or factual basis to support key assumptions, such as how Turner Broadcasting's bargaining leverage would change and how many subscribers distributors would lose in a blackout. By contrast, the Time Warner executives' testimony did "not involve promises or speculations about the employees' future, post-merger behavior" and instead recounted "what these executives previously experienced when working within a vertically integrated company." Their testimony was uniform among all testifying witnesses and corroborated by that of a Comcast-NBCU executive — a competitor of AT&T….

<u>(3) Rejection of Professor Shapiro's quantitative model.</u> Finally, the government contends that the district court clearly erred in rejecting Professor Shapiro's quantitative bargaining model. Specifically, that the district court erred in finding insufficient evidence to support Professor Shapiro's calculations of fee increases for rival distributors and in finding no proof of any price increase to consumers.

Preliminarily, the court does not hold that quantitative evidence of price increase is required in order to prevail on a Section 7 challenge. Vertical mergers can create harms beyond higher prices for consumers, including decreased product quality and reduced innovation…. Here, however, the government did not present its challenge to the AT&T-Time Warner merger in terms of creating non-price related harms in the video programming and distribution industry…

Professor Shapiro presented a quantitative model that predicted an annual net increase of $286 million being passed on to consumers in 2016, with increasing costs in future years. This figure was based on the model's predictions of an annual fee increase of $587 million for rival distributors to license Turner Broadcasting content and cost savings of $352 million for AT&T. The district court accepted Professor Shapiro's testimony about the $352 million cost savings from the merger. But it found that insufficient evidence supported the inputs and assumptions used to estimate the annual costs increases for rival distributors, crediting criticisms by Professor Carlton and Professor Rossi. Indeed, the district court found that the quantitative model as presented through Professor Shapiro's opinion testimony did not provide an adequate basis to conclude that the merger will lead to "*any*" raised costs for distributors or consumers, "much less consumer harms that outweigh the conceded $350 million in annual cost savings to AT&T's customers."

Whatever errors the district court may have made in evaluating the inputs for Professor Shapiro's quantitative model, the model did not take into account long-term contracts, which would constrain Turner Broadcasting's ability to raise content prices for distributors. The district court found that the real-world effects of Turner Broadcasting's existing contracts would be "significant" until 2021 and that it would be difficult to predict price increases farther into the future, particularly given that the industry is continually changing and experiencing increasing competition. This failure, the district court found, resulted in overestimation of how quickly the harms would occur. Professor Shapiro acknowledged that predictions farther into the future, after the long-term contracts expire, are more difficult. Neither Professor Shapiro's opinion testimony nor his quantitative model considered the effect of the post-litigation offer of arbitration agreements, something he acknowledged would require a new model. And the video programming and distribution industry had experienced "ever-increasing competitiveness" in recent years. Taken together, the government's clear-error contention therefore fails.

It is true that the district court misstated that the government had not proven that any price increases would "outweigh the conceded $350 million in annual cost saving to AT&T's customers."

Professor Shapiro testified that the merger would result in $352 million cost savings to AT&T and that not all those savings would be passed on to consumers. The $352 million, therefore, was not cost savings to consumers but to AT&T. But the district court did not weigh increased prices for consumers against cost savings for consumers, and instead found that the government had not shown at the first level that the merger was likely to lead to any price increases for consumers because of the failure to show that costs for rival MVPDs would increase as a result of Turner Broadcasting's increased leverage in affiliate negotiations after the merger. Counsel for the government and AT&T agree the error regarding the consumer savings value alone would not require remand because the district court's opinion was not based on balancing any price increases against cost savings to consumers. Consequently, because the government failed to meet its burden of proof under its increased leverage theory at the first level, the error regarding cost savings was harmless error.

Accordingly, because the district court did not abuse its discretion in denying injunctive relief, we affirm the district court's order denying a permanent injunction of the merger.

NOTES AND QUESTIONS ON *UNITED STATES V. AT&T*

1. Was the court right that, even without the offer to arbitrate, the merger would not materially increase Time Warner's bargaining leverage to increase prices to cable companies? When prices are negotiated, a seller's reservation price is the lowest price it would find preferable to not making a sale, and a buyer's reservation price is the highest price it would find preferable to doing without the seller's product. If the buyer's reservation price exceeds that of the seller, Nash bargaining theory, which was created by Nobel prize-winning economist John Nash, predicts that a seller and buyer will agree on a price somewhere between those reservation prices (because both are better off agreeing to that result than not having any deal) and that the price agreed to within that range turns on the parties' relative bargaining power. Here, Time Warner's reservation price would be the lowest price that Time Warner would find preferable to blacking out a cable company, i.e., to not selling its network content. Each cable company's reservation price would be the highest price it would find preferable to doing without Time Warner's network content. Each cable company's reservation price must have exceeded Time Warner's reservation price, given that all cable companies bought Time Warner network content.[18]

The U.S. expert testified that the merger would reduce the cost of "blacking out" cable companies, because any blackout would cause some of the cable company customers to switch to AT&T's MVPDs (DirecTV and U-Verse), giving offsetting profits to the merged firm. This reduction in blackout costs would thus increase Time Warner's reservation price (i.e., increase the bottom of the bargaining range), which Nash bargaining theory predicts would lead to a higher negotiated price for any level of Time Warner bargaining power other than 100%. The court accepted this theory in principle but found it did not apply to this market for the three reasons discussed below.

a. Was the court right to reject the Nash bargaining prediction on the ground that long-term blackouts are still highly costly to networks and rarely occurred? The court reasoned that even if the merger would decrease blackout costs, blackouts would remain so costly to Time Warner that the merger could make threats to blackout only "somewhat less incredible". But however low the credibility of the threat might be, it would be reflected in the bargaining power level, and Nash bargaining theory would predict that a higher reservation price would lead to a higher negotiated price at any Time Warner bargaining power level other than 100%.[19] Should a court reject

[18] *See* Carl Shapiro, *Vertical Mergers and Input Foreclosure Lessons from the* AT&T/Time Warner *Case*, 59 REVIEW OF INDUSTRIAL ORGANIZATION 303, 315 (2021).

[19] If Time Warner's bargaining power level was 100%, then any negotiated price would always equal the cable company's reservation price and thus would not be affected by an increase in Time Warner's reservation price. But an assumption of 100% Time Warner bargaining power would hardly fit the court's conclusion that Time Warner's threat not to bargain was non-credible.

such rigorous formal modeling of the incentive effects in favor of the court's own informal intuitions about the matter?

Further, was the blackout threat as non-credible at the court assumed? The court's analysis ignored several points. First, the court ignored the fact that it was also not credible for cable companies to do without these networks. In contrast, the Nash bargaining model takes into account that both sides would hurt themselves by failing to come to a deal within the bargaining range. Second, the costs of carrying out a specific blackout threat against a cable company in some specific local market could be offset if doing so would help Time Warner gain a reputation for carrying out blackout threats that would be profitable in negotiations with other cable companies and/or other local markets.[20] Third, Time Warner would just need to incur the costs of blackouts one day at a time, which could be profitable because each day the cable company would have incentives to agree to a higher price that would increase Time Warner's future profits over many days.[21] Fourth, as the court noted, there was evidence that firms in this industry actually did threaten blackouts and analyze their potential impact, which indicates that actual firms in the industry did find blackout threats sufficiently credible to take seriously. Finally, if blackout threats by network providers were always as non-credible as the court assumed, all cable companies would be able to successfully demand prices at or slightly above the marginal cost of Time-Warner and other network providers, which is inconsistent with actual observed past prices.

As for the fact that blackouts had rarely occurred, that could simply mean that past blackout threats by network providers were sufficiently credible that cable companies agreed to pay high prices, thus obviating any need to carry out the threat. After all, it would not be reasonable to conclude that nuclear deterrence must not work because during the Cold War the US never fired nuclear missiles at the Soviet Union. The past infrequency of blackouts could also reflect the fact that networks did not have as much leverage before the merger as Time Warner would have after it.

More generally, the court's belief—that threats to withhold a product are not credible because it is too costly to forego sales—conflicts with standard economic price theory. After all, the threat to deny a product is the same threat that any firm with market power uses to successfully impose supracompetitive pricing. Such threats are credible because the firm faces many buyers, and thus the firm would not want to undermine its ability to charge high prices to those other buyers by giving in to any particular buyer's insistence that it will only buy at a low price, even though it is the case that the firm makes more money selling to that buyer than not. If the court's contrary belief were correct, then the threat by any monopolist not to sell unless it receives a monopoly price is entirely non-credible, so any buyer could successfully demand to pay only marginal cost or a bit above, which is not what we observe or what economic price theory predicts. Perhaps it would have been better for the U.S. to have avoided framing the case around bargaining theory by simply arguing that the vertical merger would increase the merged firm's marginal costs of gaining sales to cable companies (because any such gained sales would now divert some sales and profits away from DirecTV), which would increase its prices under ordinary price theory.

The government expert concluded that bargaining power was 50%, so the parties would split the gains from a bargain 50-50. Shapiro *supra* note18, at 309. This 50-50 figure could be challenged. But it was supported by theoretical models predicting that result when parties have similar discount rates, by some empirical evidence from the behavioral economics literature, and by past studies showing that splits in the industry generally ranged from 25-75%. *Id.* at 309-10 & n.17; Shapiro Report p. 42 (Feb. 2, 2018), https://www.justice.gov/atr/case-document/file/1081336/download. In any event, the court did not question the government's particular estimate of bargaining power; instead, the court outright rejected the concept that changing the reservation price could ever affect the negotiated price when threating to refuse a deal in the bargaining range was unprofitable and thus, to the court, non-credible. In any event, the predicted directional effect that the merger would increase Time Warner's bargaining leverage to increase prices was not dependent on the particular estimate of Time Warner bargaining power, as long as it was not 100%.

[20] Elhauge, *Contrived Threats v. Uncontrived Warnings: A General Solution to the Puzzles of Contractual Duress, Unconstitutional Conditions, and Blackmail,* 83 U. CHICAGO LAW REVIEW 503, 532-33 (2016) (explaining how gaining a reputation that increases leverage in other bargains can make threats to carry out otherwise unprofitable actions credible).

[21] *Id.* at 531-32 (explaining how the ability to stage a threat over time can make threats credible).

b. Was the court right to reject the Nash bargaining prediction on the ground that past vertical mergers had not increased prices? The main example cited by the court and the defense was the NBC-Comcast merger. But that merger was governed by a consent decree that banned blackouts and required arbitration between each side's final offer. To be sure, in this case, Time Warner "irrevocably offered" the same arbitration without blackouts for seven years, but that does not explain why the court held there would be no anticompetitive effects even *without* that arbitration offer. Moreover, as discussed below, the Time Warner offer to arbitrate did not seem to be legally binding, unlike the arbitration requirement imposed by the NBC-Comcast consent decree.

In addition, in this case, the merged firm might be willing to provoke a greater number of arbitrations or to seek higher prices within those arbitrations, for two reasons. First, in this case the merged firm might have greater market power over upstream network content because it could withhold HBO, CNN, TNT, TBS and Warner Brothers, whereas in that case the merged firm could only withhold an NBC network that was also available for free on the airwaves. Second, in this case, there might be greater competition in the downstream distribution markets, either because such markets became more competitive from 2011 to 2019 or because AT&T's MVPDs could compete with more cable companies than Comcast could. Such increased downstream competition would mean blackouts or higher prices would cause a greater downstream diversion of profits to AT&T's MVPDs from cable companies, thus reducing blackout costs and increasing bargaining leverage and prices.

The other evidence offered was that the split of other prior vertical mergers (News Corp.-DirecTV in 2008 and Time Warner Cable-Time Warner in 2009) did not change prices. But again, in this case, the merger seemed to involve greater market power over upstream network content and greater downstream distribution competition, so could create greater anticompetitive effects.

Moreover, the defense never applied the U.S.'s Nash bargaining model to those prior mergers and splits to see if it would have predicted price changes from them. Without such evidence, the lack of price changes from those prior mergers and splits does nothing to undermine the predictions of the Nash bargaining model in this case.

The loose approach used to infer an absence of anticompetitive effects from past vertical mergers or splits, without any effort to control for their differences, is quite different from the approach courts typically use when deciding whether to find anticompetitive effects. If a plaintiff tried to argue that a merger would increase prices because past mergers had increased prices, courts would typically require more rigorous evidence that the past mergers were very similar to the current merger and that the plaintiff's study controlled for any differences between them.

c. Was the court right to reject the Nash bargaining prediction because the court credited business testimony that said there would be no significant increase in leverage over other business testimony that said the opposite?

<u>i. 2009 Statements by ATT and DirecTV</u>. In 2009, ATT and DirecTV stated that the NBC-Comcast merger would create increased bargaining leverage based on the same Nash bargaining theory that in this case they claimed did not apply to the industry. The court rejected these statements on three grounds.

First, the court noted that ATT and DirecTV were competitors of the downstream merging firm in that 2009 case and thus they had suspect incentives because an efficient merger would harm competitors. But their incentives were are worst mixed because ATT and DirecTV were also purchasers of upstream content from NBC, and that role gave them offsetting incentives to object only if they truly believed that the merger would increase upstream prices. The district court opinion indicated that their 2009 statements were also consistent with their internal documents, which helps indicate that they were not posturing. Moreover, the court's dismissal of their statements on this ground seems inconsistent with the fact that in this case the court credited testimony in support of the Time Warner-ATT merger from Time Warner, which was directly interested in having the merger approved, and NBC-Comcast, a vertically integrated competitor whose incentives were, if anything,

more suspect because it could benefit from an anticompetitive merger that increased prices at either level. Indeed, the court credited Time Warner's testimony even though it conflicted with its internal documents. It is hard to see a neutral principle for concluding that a buyer/competitor's incentives are too suspect to credit their statements *against* a merger, even when those statements are *consistent* with their internal documents, but that a merging firm and two-level competitor's incentives are not too suspect to credit those statements *for* a merger, even when they *conflict* with their internal documents.

Second, the court noted that the 2009 statements of ATT and DirecTV did not necessarily extend to the more competitive market that existed in 2019. But that fact could cut in the opposite direction, because increased downstream competition would increase the diversion of downstream profits from cable companies to AT&T's MVPDs from any blackout, thus reducing the costs of carrying out a blackout threat and increasing prices for network content.

Third, the court stressed that the 2009 statements of ATT and DirecTV about the NBC-Comcast merger were proven wrong because it turned out that that merger did not increase prices. But maybe the only reason it did not do so was that that merger was governed by a binding arbitration provision.

ii. Trial testimony. The court credited testimony by executives from Time Warner and NBC-Comcast, who testified that past vertical integration had not affected their negotiations. But the court rejected testimony from rival MVPDs that this merger would increase bargaining leverage. The court gave two reasons to reject the latter testimony but not the former.

First, the court noted that the testimony by rival MVPDs was self-interested. But was not the testimony of Time Warner and NBC-Comcast even more self-interested? Time Warner was a merging party and thus had a clear self-interest in defending its merger. NBC-Comcast was a vertically integrated firm that would compete with a merged Time Warner-ATT at two market levels and thus would have a self-interested motive to favor an anticompetitive merger that raised prices in those markets. In addition to that suspect competitor incentive, NBC-Comcast would not want to admit that its own past merger might have been anticompetitive. In contrast, the incentives of rival MVPDs were at worst mixed. To be sure, as MVPDs that competed with AT&T's MVPDs, rival MVPDs had incentives to want to stop a merger that efficiently lowered prices at AT&T's MVPDs. On the other hand, as buyers of network content, MVPDs have good incentives to want to block the merger only if they thought that the merger would anticompetitively increase the network content prices that they paid.

Second, the court reasoned that the Time Warner and NBC-Comcast testimony was about their concrete past experience, whereas the testimony by rival MVPDs was speculation about the future. But the Time Warner and NBC-Comcast testimony was really just *their characterization* of their past experience, which involved their own speculation about whether their negotiations had been affected by past vertical integration. Moreover, the MVPDs presumably relied on their own past experience with negotiations as the basis for their predictions about how this merger would affect their future bargaining leverage.

2. Did the arbitration offer in this case eliminate any potential anticompetitive effects? The court concluded that in this case Time Warner's decision to offer arbitration to approximately 1000 MVPDs would constrain any increased bargaining leverage. But this raised three issues.

First, although the court described this arbitration offer as "irrevocable", was it legally binding? After all, from the court's own description, the arbitration offers were not exchanged for any consideration, and thus under contract law such offers could be revoked at any time before acceptance. Nor was a commitment to arbitrate made part of any consent decree, and the court emphasized that the offers to arbitrate were not necessary for the court's holding and thus keeping them in place would not be necessary to sustain the merger.

Second, even if the arbitration offers were legally binding, if the merger increased Time Warner's bargaining leverage, would not it be willing to provoke a greater number of arbitrations and to seek

higher prices in those arbitrations? To be sure, with binding arbitration a blackout could not occur. But it would remain the case that higher network prices to cable companies would tend to increase the latter's downstream prices, which would divert some sales and profits to ATT's MVPDs. Thus, Time Warner would have incentives to provoke more arbitrations and to seek higher prices in those arbitrations. Further, because the prices set in arbitration are generally set based on prices agreed to in the past by MVPDs, arbitration would increase not only Time Warner's incentive to seek higher prices from other MVPDs, but also its ability to stave off a decline in prices that might have resulted if its degree of market power would otherwise have waned over time.[22]

Third, Time Warner's offer to arbitrate was offered only to MVPDs with at least 1 million subscribers that received Time Warner network content as of November 2017.[23] The offer thus did nothing to protect other MVPDs.

Fourth, Time Warner's offer to arbitrate was limited to seven years, so could not avert anticompetitive effects after that time. The court reasoned that one should ignore effects after seven years because, given technological trends, by then the distribution market might include not only MVPDs but also SVODs like Netflix and Hulu. But the latter would still need someone to connect them to homes, so they would be subject to the same bargaining leverage. Further, any future increase in distribution competition might (as noted above) instead increase the merged firm's incentives to divert business to ATT's MVPDs, worsening the anticompetitive effects. More generally, the court's approach, if followed by other courts, would mean that in any dynamic market that cannot be precisely modeled in the long run, firms could always lock in a possible future anticompetitive advantage with a short-term promise.

3. Did the U.S. fail to prove that the size of its predicted anticompetitive effects outweighed the procompetitive effects? Even if the merger did increase Time Warner's bargaining leverage to increase prices, the appellate court found that the U.S. model exaggerated the *size* of this effect for two reasons. First, the U.S. expert ignored the effect of long-term contracts, which would have some constraining effect on price increases until 2021, by which time the market would be different. The U.S. model would still apply to any contract that was up for renewal and 2021 was only two years away, but considering this factor would alter the size of the predicted anticompetitive effects. Second, the U.S. expert ignored the effect of the arbitration offer. Even if (for reasons discussed above) the arbitration offer would not eliminate all anticompetitive effects, it would seem like it would alter the size of those effects in a way that should be considered.

To be sure, the above defects only went to the size of the predicted increase in Time Warner's bargaining leverage to increase prices and thus would not alter the conclusion that the direction of that effect was anticompetitive. However, the U.S. expert acknowledged that the merger would eliminate double marginalization in a way that would reduce costs by $352 million, $301 million of which would be passed on to consumers. He found this efficiency offset by his prediction that the increased bargaining leverage would raise consumer prices by $587 million, but that meant he had to accurately quantify the size of the impact of increased bargaining power, because if it was anything less than $301 million, he would no longer predict a net anticompetitive effect.[24] The court did not bother to balance anticompetitive effects against procompetitive effects because it found (based on the above dubious logic) that the U.S. had not proven any likely anticompetitive effect. But even if the court had found some likely anticompetitive effects, these problems with the U.S. model would seem

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[22] *See* Shapiro Report, *supra* note 19, at 97-98; Shapiro Rebuttal Report 51-53 (Feb 26, 2018), https://www.justice.gov/atr/case-document/file/1081321/download.

[23] *See* Shapiro Report, *supra* note 19, at 96.

[24] The government expert did offer analysis showing that taking into account the fact that long-term contracts would delay anticompetitive harm for a year or two would not, standing alone, alter his conclusion that the anticompetitive effects would outweigh the procompetitive effects. *See* Shapiro *supra* note 18, at 319. But he did not offer analysis showing that taking into account *both* issues would lead to predicted anticompetitive effects that still exceeded his estimate of efficiencies.

to mean that the U.S. failed to carry its burden to show their magnitude exceeded the acknowledged efficiencies.

A stronger argument for the U.S. might have been to argue that double marginalization could have been eliminated through less anticompetitive alternatives. Perhaps Time Warner could instead have eliminated double marginalization by using two-part pricing, charging a lump sum for the right to buy any network content coupled with a low marginal cost for each additional subscriber added by the cable company. Or perhaps Time Warner and downstream MVPDs could have eliminated double marginalization with vertical maximum agreements that set both the upstream price to MVPDs and the maximum per subscriber downstream price to consumers.

The U.S. expert did not rely on such less anticompetitive alternatives because there was no evidence that the industry had used or planned to use such contractual solutions to eliminate double marginalization, and the U.S. agencies' 2010 horizontal merger guidelines had stated that the agencies would consider only "alternatives that are practical in the business situation" and not alternatives that were "merely theoretical".[25] The subsequent 2020 Vertical Merger Guidelines broadened this point to say that the U.S. agencies would not consider less anticompetitive alternatives that were "not reflected in documentary evidence."[26] Should the U.S. agencies decline to rely on less anticompetitive alternatives that are not confirmed by documentary evidence that the industry has used or planned to use such alternatives, even if those alternatives should in theory eliminate the double marginalization problem just as effectively as the proposed merger and no concrete practical impediments to those alternatives have been shown? Is there a risk that refusing to consider such alternatives on this basis might encourage industry participants not to use or consider such alternatives precisely so that they could justify future vertical mergers? If so, refusing to consider such alternatives when assessing vertical mergers might not only distort merger analysis, but also lead to fewer efficient contract corrections of double marginalization outside of mergers.

U.S. DOJ/FTC, Vertical Merger Guidelines

(2020)

1. OVERVIEW…[27]

… These Guidelines describe how the agencies analyze a range of non-horizontal transactions. Where they use the term "vertical," that term should not be read to narrow the applicability of these Guidelines. The analytical techniques, practices, and enforcement policies described in these Guidelines apply to strictly vertical mergers (those that combine firms or assets at different stages of the same supply chain), "diagonal" mergers (those that combine firms or assets at different stages of competing supply chains), and vertical issues that can arise in mergers of complements. In describing a vertical relationship, a stage closer to final consumers (such as a distributor, retailer, or finished goods manufacturer) is termed "downstream," and a stage further from final consumers (such as a supplier, wholesaler, or input manufacturer) is termed "upstream."

Mergers often present both horizontal and vertical elements, and the Agencies may apply both the Horizontal Merger Guidelines and the Vertical Merger Guidelines in their evaluation of a transaction. In addition, if one of the parties to a transaction could use its pre-existing operations to facilitate entry into the other's market, the Agencies may consider whether the merger removes competition from a potential entrant, using the methods described in the

[25] *See* Shapiro *supra* note 18, at 323-24.

[26] U.S. DOJ/FTC, VERTICAL MERGER GUIDELINES §(2020).

[27] [1] These Guidelines supersede the extant portions of the Department of Justice's 1984 Merger Guidelines, which are now withdrawn and superseded in their entirety….

Horizontal Merger Guidelines…. Other topics addressed in the Horizontal Merger Guidelines, but not addressed herein – such as the analytic framework for evaluating entry considerations, the treatment of the acquisition of a failing firm or its assets, and the acquisition of a partial ownership interest – are relevant to the evaluation of the competitive effects of vertical mergers as well….

As with horizontal mergers, the Agencies normally examine effects on the actual and potential direct customers of the merging parties, and, if different, the final consumers of firms that utilize the goods or services of the merging parties. The Agencies are concerned with harm to competition, not to competitors. When a merger involves products at different levels of a supply chain, the direct customers the Agencies will consider are actual and potential buyers of the downstream products. Absent convincing evidence to the contrary, the Agencies presume that adverse effects on these direct customers lead to adverse effects on final consumers.

The enhancement of market power by buyers, sometimes called "monopsony power," has adverse effects comparable to the enhancement of market power by sellers. The Agencies employ an analogous framework to analyze vertical mergers that may enhance the market power of buyers….

2. EVIDENCE OF ADVERSE COMPETITIVE EFFECTS

The Agencies consider any reasonably available and reliable evidence to address the central question of whether a vertical merger may substantially lessen competition. The types of evidence described in Section 2.1 of the Horizontal Merger Guidelines can also be informative about the effects of vertical mergers, including actual effects observed in consummated mergers, direct comparisons based on experience, and evidence about the disruptive role of a merging party. The Agencies may also consider evidence about the disruptive role of non-merging firms – for example, when evaluating a theory that a vertical merger may allow the merged firm to discipline disruptive rivals. The Agencies may also consider market shares and concentration in relevant markets (*see* Section 3), and may rely on evidence of head-to-head competition between one merging firm and rivals that trade with the other merging firm when evaluating unilateral effects (*see* Section 4). The sources of evidence on which the Agencies rely are the same as those set forth in Section 2.2 of the Horizontal Merger Guidelines and include documents and statements of the merging parties, their customers, and other industry participants and observers.

3. MARKET DEFINITION, RELATED PRODUCTS, MARKET SHARES, AND CONCENTRATION

In any merger enforcement action involving a vertical merger, the Agencies will normally identify one or more relevant markets in which the merger may substantially lessen competition. Many of the general purposes and limitations of market definition described in Section 4 of the Horizontal Merger Guidelines are also relevant when the Agencies define markets for vertical mergers, and the Agencies generally use the methodology set forth in Sections 4.1 and 4.2 of the Horizontal Merger Guidelines to define relevant markets for vertical mergers.

When the Agencies identify a potential competitive concern in a relevant market, they will also specify one or more related products. A related product is a product or service that is supplied or controlled by the merged firm and is positioned vertically or is complementary to the products and services in the relevant market. For example, a related product could be an input, a means of distribution, access to a set of customers, or a complement. The same transaction can give rise to more than one vertical concern, and different concerns may affect different relevant markets.

Example 1: Relevant markets can be upstream or downstream

Situation: A retail chain buys the manufacturer of Brand A cleaning products.

Discussion: In this example, the merged firm's supply of Brand A cleaning products (the related product) could affect downstream competition between retailers in a given geographic

area (the relevant market). The Agencies may also consider whether the merged firm's retailing of cleaning products in a given geographic area (the related product) could affect competition between manufacturers of cleaning products in that area (the relevant market).

The Agencies may consider measures of market shares and market concentration in a relevant market in their evaluation of competitive effects. The Agencies evaluate market shares and concentration in conjunction with other reasonably available and reliable evidence for the ultimate purpose of determining whether a merger may substantially lessen competition.

The Agencies use the methodology set out in Section 5 of the Horizontal Merger Guidelines to measure shares and concentration in a relevant market, but do not rely on the thresholds in Section 5.3 as screens for or indicators of competitive effects from vertical theories of harm. Existing levels of concentration may nonetheless be relevant. For example, high concentration in the relevant market may provide evidence about the likelihood, durability, or scope of anticompetitive effects in that relevant market.

4. UNILATERAL EFFECTS

A vertical merger may diminish competition between one merging firm and rivals that trade with, or could trade with, the other merging firm. This section discusses common types of unilateral effects arising from vertical mergers. Section (a) discusses foreclosure and raising rivals' costs. Section (b) discusses competitively sensitive information. These effects do not exhaust the types of possible unilateral effects.

a. Foreclosure and Raising Rivals' Costs

A vertical merger may diminish competition by allowing the merged firm to profitably use its control of the related product to weaken or remove the competitive constraint from one or more of its actual or potential rivals in the relevant market. For example, a merger may increase the vertically integrated firm's incentive or ability to raise its rivals' costs by increasing the price or lowering the quality of the related product. The merged firm could also refuse to supply rivals with the related products altogether ("foreclosure").

In identifying whether a vertical merger may diminish competition due to unilateral foreclosure or raising rivals' costs,[28] the Agencies generally consider whether the following conditions are satisfied:

(1) *Ability*: By altering the terms by which it provides a related product to one or more of its rivals, the merged firm would likely be able to cause those rivals (a) to lose significant sales in the relevant market (for example, if they are forced out of the market; if they are deterred from innovation, entry, or expansion, or cannot finance those activities; or if they have incentives to pass on higher costs through higher prices) or (b) to otherwise compete less aggressively for customers' business.

This element would not be satisfied, and in turn a merger would rarely warrant close scrutiny for its potential to lead to foreclosure or raising rivals' costs, if rivals could readily switch purchases to alternatives to the related product, including self-supply, without any meaningful effect on the price, quality, or availability of products or services in the relevant market.

The Agencies' review of the merged firm's rivals' ability to switch to alternatives to the related product may include, but is not limited to, the types of evidence the Agencies use to evaluate customer switching when implementing the hypothetical monopolist test, listed in Section 4.1.3 of the Horizontal Merger Guidelines.

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[28] [4] For ease of exposition, the principal discussion is about input foreclosure and raising rivals' input costs following a merger between vertically related firms, where the concern is that the merged firm could profitably use its supply of an input (the related product) to weaken the competitive constraint it faces from rivals in the downstream market (the relevant market). Examples in this section discuss the analogous analysis for foreclosure or raising rivals' costs that raise barriers to entry, customer foreclosure and raising rivals' distribution costs, and mergers of complements.

(2) *Incentive*: The merged firm, as a result of the merger, would likely find it profitable to foreclose rivals, or offer inferior terms for the related product, because it benefits significantly in the relevant market when rivals lose sales or alter their behavior in response to the foreclosure or to the inferior terms.

This element would not be satisfied, and in turn a merger would rarely warrant close scrutiny for its potential to induce foreclosure or raise rivals' costs, if the merged firm would not benefit from a reduction in actual or potential competition with users of the related product in the relevant market.

The Agencies' assessment of the effect of a vertical merger on the incentive to foreclose rivals or raise their costs by changing the terms of the related product will be fact-specific. For example, in the case of foreclosure, the Agencies generally consider whether the merged firm's gains in the relevant market would likely outweigh any losses from reduced sales of the related product.

Mergers for which these conditions are met potentially raise significant competitive concerns and often warrant scrutiny.

For mergers that warrant scrutiny, the Agencies will determine whether, based on an evaluation of the facts and circumstances of the relevant market, the merger may substantially lessen competition. This evaluation will generally include an assessment of the likely net effect on competition in the relevant market of all changes to the merged firm's unilateral incentives. The merged firm may foreclose its rivals or raise their costs by changing the terms offered for the related product, but a vertical merger can also change other incentives. The elimination of double marginalization, for example, can confer on the merged firm an incentive to set lower downstream prices. The price that a downstream firm pays for an input supplied by an independent upstream firm may include a markup over the upstream firm's marginal cost. If a downstream and an upstream firm merge, and the merged firm supplies itself with its own related product, it will have access to the input at cost. (*See* Section 6.) The likely merger-induced increase or decrease in downstream prices would be determined by considering the impact of both these effects, as well as any other competitive effects.

To the extent practicable and appropriate, the Agencies will use the same set of facts and assumptions to evaluate both the potential harm from a vertical merger and the potential benefits of the elimination of double marginalization, and will focus on evaluating conduct that would be most profitable for the merged firm as a whole.

Where sufficient relevant data are available, the Agencies may construct economic models designed to quantify the net effect on competition. The Agencies may employ merger simulation models to assist in this quantitative evaluation. These models often include independent price responses by non-merging firms and may incorporate feedback from the different effects on incentives. The Agencies do not treat merger simulation evidence as conclusive in itself, and they place more weight on whether merger simulations using reasonable models consistently predict substantial price increases than on the precise prediction of any single simulation. The Agencies may also determine that a merger may substantially lessen competition based on an evaluation of qualitative evidence of all potential effects.

The next paragraphs provide illustrative examples of the application of this general framework. The examples do not exhaust the types of possible foreclosure concerns.

Example 2: Input foreclosure and raising rivals' costs

Situation: Upstream firms supply oranges to downstream firms, which use the oranges to produce orange juice. All orange suppliers make take-it-or-leave-it offers to sell at constant

unit prices.[29] A supplier of oranges (the related product) merges with a producer of orange juice (the relevant market) that buys its entire orange demand from the supplier.

Discussion: The merged firm may have the ability to restrict the supply of oranges to rival orange juice producers. If those rivals lack alternative sources of oranges to those of the merged firm in sufficient quantity at comparable price and quality, the merged firm may be able to increase their costs by raising the price at which it sells them oranges or by refusing to sell them oranges altogether.

The Agencies may assess whether the merged firm would likely have an incentive to raise the price at which it supplies oranges to rivals. This assessment may focus on the resulting reduction in competition, including any reduction due to the diversion of sales of orange juice to the merged firm. Capturing the downstream margin on the diverted sales through merger may make a price increase profitable, even though the price increase would not be profitable for the orange supplier absent the merger. The effect on the price the merged firm charges for oranges depends on the merged firm's gains from diverted sales in the relevant market and from increased prices in the relevant market.

The Agencies may also consider whether the merged firm may have an incentive to stop supplying oranges to rival orange juice producers altogether. In doing so, the merged firm would lose the margin on the forgone sales of oranges, but may benefit from a higher margin and increased sales of orange juice diverted from its rivals. If the benefits from increased downstream sales outweigh the costs of the forgone upstream sales, the merged firm may find it profitable to foreclose.

In either case, the merged firm will likely source its oranges at reduced cost rather than paying a price that includes a margin to an independent firm, giving it an incentive to set lower prices on its own orange juice products (the effects of eliminating double marginalization). To determine whether the merger may substantially lessen competition, the Agencies would analyze the specific facts and circumstances, including in particular the relative magnitude of these offsetting incentives.

Example 3: Raising the input costs of rivals with bargaining

Situation: A firm supplies Product A to a number of competing downstream retailers, each of which would lose significant business overall if it did not stock Product A. Terms are set through bargaining, and contracts take the form of constant unit wholesale prices. The supplier of Product A merges with one of the retailers.

Discussion: The vertical merger may diminish competition between retailers (the relevant market) by giving the merged firm the leverage to raise its rivals' costs by negotiating increased wholesale prices for the firm's supply of Product A (the related product) from its rival retailers. Compared to the manufacturer of Product A acting independently, the merged firm may benefit downstream if it refuses to supply one or more of its downstream rivals and if such rivals lose sales as a result. This benefit improves the merged firm's alternative to a supply agreement should negotiations take time to resolve, or fail altogether, and thus may increase the merged firm's bargaining leverage with rival retailers.

Rivals that pay higher wholesale prices for Product A would likely set higher retail prices. In contrast, the merged firm will likely lower its costs for sourcing Product A because it will not pay a wholesale price to a third party that includes a markup over cost, providing the merged firm with an incentive to lower its retail price for Product A. It is a factual question whether competition in the retail market would be substantially lessened, such that consumers in the retail market would pay higher prices, on average, after the merger.

[29] [5] By "constant unit prices," we refer to a simple linear price per-unit with no other fees or offsets. The pricing structure is relevant to the likelihood and the degree of both raising rivals' costs and the elimination of double marginalization.

Example 4: Creating the need for two-level entry

Situation: Company A is the sole supplier of an active ingredient required to make an off-patent pharmaceutical drug produced only by Company B. Company A's supply of the active ingredient is the related product. It sets a constant unit price. Company C is considering entering the relevant market with its own version of the drug. Were it to enter, head-to-head competition with Company B would be significant and prices for the drug would likely fall significantly, leading to increased sales. Company B buys Company A. In the absence of the merger, Company A would benefit from Company C's entry.

Discussion: The merger may diminish competition in the relevant market by making entry by Company C less likely. In the absence of the merger, Company A would likely have an incentive to facilitate the entry of Company C and to supply Company C if it did enter. The merged firm, on the other hand, may have the ability to prevent Company C from successfully entering the relevant market by refusing to supply Company C with any active ingredient. In this case, Company C's successful entry into the relevant market may require Company C to produce the active ingredient as well. This two-level entry may be more costly and riskier than entering the relevant market alone, and thus may deter Company C from entering. Moreover, the merged firm may have an incentive to refuse to supply Company C unless it is markedly more efficient or targeting additional customer groups or markets.

The Agencies would also consider the effects on competition if the merged firm would eliminate double marginalization by sourcing the active ingredient at cost rather than paying a price that included a markup. The likely net effect on competition in the relevant market would depend, in part, on the extent to which entry was likely absent the merger.

Example 5: Raising rivals' costs of distribution

Situation: A distributor of components to customize trucks for different uses offers competing liftgates for loading. Liftgates are supplied at a constant unit wholesale price. The distributor buys a manufacturer of liftgates. The distributor has developed a strong position in Region X based on offering superior support and developing close customer relationships. Many customers consider other distributors to be inadequate substitutes for the merged firm's distribution of liftgates in Region X (the related product).

Discussion: The Agencies may consider whether the merger would harm competition in the market for the manufacture of liftgates in Region X (a relevant market). Because customers prefer the merged firm's superior distribution service, the merged firm may be able to disadvantage manufacturers of rival liftgates by setting higher retail prices for their products. The profitability of such a strategy would depend on diversion to the merged firm's liftgates as well as sales lost to rival distributors.

A potential harm in this example is diminished competition between manufacturers of liftgates (a relevant market upstream from the market for the distribution of liftgates). The Agencies, however, may consider the impact on retail prices when evaluating the effects on competition in the relevant market. The competitiveness of upstream manufacturers depends, in part, on the derived demand from customers of the downstream distributors, who choose among manufacturers' products based on downstream retail prices. Competition in the retail sale of liftgates may be harmed if the merged firm raises retail prices for rival brands, even though rival manufacturers may respond to the change in the merged firm's incentives by setting lower, not higher, wholesale prices. The Agencies would also evaluate the extent of the merged firm's incentive to set a lower price for liftgates because of the elimination of double marginalization.

Example 6: Merger of complements raising vertical issues

Situation: Manufacturers use batteries and motors when making electric scooters. Electric scooter manufacturers use different batteries and motors based on their production

technologies. The two components are complements: manufacturers make more scooters, and demand more of both components, when the price of either component falls. All components are sold under contracts that specify a constant unit price. The leading maker of motors for scooters merges with a manufacturer of batteries for scooters.

Discussion: Motors and batteries are complementary inputs into the production of electric scooters. Neither input is upstream nor downstream from the other in the supply chain. The Agencies may investigate whether the merged firm would have the ability and incentive to disadvantage rival manufacturers of batteries. For example, the merged firm might do so by increasing the price of its motors (the related product) to its customers (*e.g.*, electric scooter manufacturers) that do not also buy the merged firm's batteries. The merged firm may also have an incentive to offer lower prices for batteries to its customers that do buy both components from it. If the Agencies conclude that both countervailing price effects are likely to be present post-merger, the Agencies will conduct a balancing of the effects to determine the net effect on the prices customers will likely pay.

The Agencies may also use an analysis similar to the above to investigate whether the merged firm would have the ability and incentive to disadvantage rival manufacturers of motors (in an additional relevant market) by increasing the price of batteries (the related product) to its customers that do not also buy the merged firm's motors.

Example 7: Diagonal merger

Situation: An electronics firm develops a component that enhances the wireless capability of low-end laptop computers. This component intensifies competition between low-end laptop computers that incorporate the component as an input and high-end laptop computers that already provide premium wireless capabilities without the component. The largest manufacturer of high-end laptop computers with premium wireless capability acquires this electronics firm. The acquisition neither expands nor improves the functionality that the acquiring firm can provide. The acquired technology is not compatible with the acquiring firm's products, and redesigning its products to incorporate the acquired technology would neither lower its marginal costs nor improve the wireless capabilities of its laptops.

Discussion: The Agencies may investigate whether the merged firm would have the ability and incentive to reduce competition in the market for laptop computers (a relevant market) by increasing the price, degrading the quality, or reducing the availability of the component providing wireless capability (the related product). 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.

b. Access to Competitively Sensitive Information

In a vertical merger, the transaction may give the combined firm access to and control of sensitive business information about its upstream or downstream rivals that was unavailable to it before the merger. For example, a downstream rival to the merged firm may have been a premerger customer of the upstream firm. Post-merger, the downstream component of the merged firm could now have access to its rival's sensitive business information. In some circumstances, the merged firm can use access to a rival's competitively sensitive information to moderate its competitive response to its rival's competitive actions. For example, it may preempt or react quickly to a rival's procompetitive business actions. Under such conditions, rivals may see less competitive value in taking procompetitive actions. Relatedly, rivals may refrain from doing business with the merged firm rather than risk that the merged firm would use their competitively sensitive business information as described above. They may become less effective competitors if they must rely on less preferred trading partners, or if they pay higher prices because they have fewer competing options.

5. COORDINATED EFFECTS

In some cases, a vertical merger may diminish competition by enabling or encouraging post-merger coordinated interaction among firms in the relevant market that harms customers. Section 7 of the Horizontal Merger Guidelines describes how the Agencies evaluate coordinated effects. In particular, Section 7.1 notes that the Agencies are more likely to challenge a merger on the basis of coordinated effects when the relevant market shows signs of vulnerability to coordinated conduct, and the Agencies have a credible basis on which to conclude that the merger may enhance that vulnerability. Section 7.2 sets forth evidence relevant to evaluating whether a market is vulnerable to coordination. The theories of harm discussed in the Horizontal Merger Guidelines, as well as those discussed below, are not exhaustive, but rather are illustrations of the manner in which a merger may lessen competition due to coordinated effects.

A vertical merger may enhance the market's vulnerability to coordination by eliminating or hindering a maverick firm that otherwise plays or would play an important role in preventing or limiting anticompetitive coordination in the relevant market. For example, the merged firm could use its control over a related product or service to harm the ability of a non-merging maverick to compete in the relevant market, thereby increasing the likelihood of coordinated interaction among the merged firm and rivals participating in that market.

Coordinated effects may also arise in other ways, including when changes in market structure or the merged firm's access to confidential information facilitate (a) reaching a tacit agreement among market participants, (b) detecting cheating on such an agreement, or (c) punishing cheating firms.

Example 8: Vertical merger raising coordinated effects issues

Situation: A merger combines a manufacturer of components and a maker of final products.

Discussion: Where the component manufacturer supplies rival makers of final products, it will have information on the rival's volume of final product, and thus will be better able to detect cheating on a tacit agreement to limit the output of final products. As a result, the merger may make an agreement to limit supply more effective.

Some effects of a vertical merger may make the market less vulnerable to coordination. For example, a vertical merger's elimination of double marginalization (*see* Section 6) may increase the merged firm's incentive to cheat on a tacit agreement, thereby reducing the risk of coordinated effects.

6. PROCOMPETITIVE EFFECTS

Vertical mergers combine complementary economic functions and eliminate contracting frictions, and therefore have the capacity to create a range of potentially cognizable efficiencies that benefit competition and consumers. Vertical mergers combine complementary assets, including those used at different levels in the supply chain, to make a final product. A single firm able to coordinate how these assets are used may be able to streamline production, inventory management, or distribution. It may also be able to create innovative products in ways that would not likely be achieved through arm's-length contracts.

The Agencies evaluate efficiency claims by the parties using the approach set forth in Section 10 of the Horizontal Merger Guidelines, as elaborated here. Cognizable efficiencies are merger-specific efficiencies that have been verified and do not arise from anticompetitive reductions in output or service. The Agencies do not challenge a merger if cognizable efficiencies are of a

character and magnitude such that the merger is unlikely to be anticompetitive in any relevant market.[30]

Due to the elimination of double marginalization, mergers of vertically related firms will often result in the merged firm's incurring lower costs for the upstream input than the downstream firm would have paid absent the merger. This is because the merged firm will have access to the upstream input at cost, whereas often the downstream firm would have paid a price that included a markup. The elimination of double marginalization is not a production, research and development, or procurement efficiency; it arises directly from the alignment of economic incentives between the merging firms. Since the same source drives any incentive to foreclose or raise rivals' costs, the evidence needed to assess those competitive harms overlaps substantially with that needed to evaluate the procompetitive benefits likely to result from the elimination of double marginalization.

Mergers of firms that make complementary products can lead to a pricing efficiency analogous to the elimination of double marginalization. Absent the merger, the merging parties would set the price for each complement without regard to the impact of lower prices for one on demand for the other. If the two merge, the merged firm has an incentive to set prices that maximize the profits of the firm as a whole, which may result in lower prices for each component. Any incentive to offer lower prices may be more pronounced if the merged firm can target lower prices at customers that buy both components from it.

While it is incumbent upon the merging firms to provide substantiation for claims that they will benefit from the elimination of double marginalization, the Agencies may independently attempt to quantify its effect based on all available evidence, including the evidence they develop to assess the potential for foreclosure or raising rivals' costs. In verifying the elimination of double marginalization, the agencies typically examine the likely cost saving to the merged firm from self-supplying inputs that would have been purchased from independent suppliers absent the merger. Creditable quantifications of the elimination of double marginalization are generally of similar precision and reliability to the Agencies' quantifications of likely foreclosure, raising rivals' costs, or other competitive effects.

In assessing the merger-specificity of the elimination of double marginalization, the Agencies typically examine whether it would likely be less costly for the merged firm to self-supply inputs following the merger than for the downstream firm to purchase them from one or more independent firms absent the merger. The merging parties' evidence about existing contracting practices is often the best evidence of the price the downstream firm would likely pay for inputs absent the merger. The Agencies also consider other evidence, such as contracts between similarly situated firms in the same industry and contracting efforts considered by the merging firms. The Agencies do not, however, reject the merger specificity of the elimination of double marginalization solely because it could theoretically be achieved but for the merger, if such practices are not reflected in documentary evidence. The Agencies will generally take the same approach to evaluate the likely contractual arrangements absent the transaction as the one they use when evaluating raising rivals' costs or foreclosure.

The Agencies' assessment of the effects of the elimination of double marginalization on competition in the relevant markets relative to unilateral and coordinated effects is described further in Sections 4 and 5.

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[30] [6] The Agencies in their prosecutorial discretion may also consider efficiencies that are not strictly in the relevant market, using the principles set out in footnote 14 of the Horizontal Merger Guidelines.

FTC Withdrawal from the Vertical Merger Guidelines

(2021)

■ **Statement of FTC Chair Lina M. Khan, Commissioner Rohit Chopra, and Commissioner Rebecca Kelly Slaughter.**

Section 7 of the Clayton Act prohibits mergers and acquisitions "where in any line of commerce or in any activity affecting commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly." Mergers or agreements to merge can also violate the prohibitions on restraints of trade, monopolization, or unfair methods of competition. Despite these laws, over the past several decades the country has seen increasing levels of consolidation across the economy—much of it via merger—and a reduction in new firm formation. That consolidation has led to a corresponding lessening of competition reflected in growing mark-ups and shrinking wages.

In light of these developments, the Federal Trade Commission and the Department of Justice are reviewing their approach to enforcing the antitrust laws' prohibition of anticompetitive mergers. As an immediate step, the FTC is withdrawing its approval of the Vertical Merger Guidelines issued in 2020 ("2020 VMGs") to prevent further industry or judicial reliance on certain flawed provisions. In particular, the 2020 VMGs' flawed discussion of the purported procompetitive benefits (i.e., efficiencies) of vertical mergers, especially its treatment of the elimination of double marginalization ("EDM"),[31] could become difficult to correct if relied on by courts.

The 2020 VMGs represent a substantial improvement over the 1984 guidelines that they replaced and address important principles such as raising rivals' costs, foreclosure, and misuse of competitively sensitive information. Going forward, the FTC intends to work with the Department of Justice to issue updated merger guidance. This update will provide an opportunity to build on the positive steps that were taken in the 2020 VMGs. In particular, our review will enable consideration of key economic evidence that has been developed about the impact of market structure on the likely competitive effects of a merger.[32] It will also provide an opportunity to directly analyze mergers affecting critical areas of our modern economy, such as digital gatekeepers and labor markets.

Until new guidance is issued, the FTC will analyze mergers in accordance with its statutory mandate, which does not presume efficiencies for any category of mergers. In any merger, the FTC will consider all relevant facts, including but not limited to market structure, to determine whether a merger may lessen competition or tend to create a monopoly….

I. BACKGROUND

The 2020 VMGs were the first update to the FTC's and Department of Justice's published guidance on vertical mergers since 1984. The 1984 vertical merger guidelines no longer reflected agency practice or modern economics, and their withdrawal in early 2020 was a key step toward

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[31] [8] The 2020 Guidelines do not refer to EDM as an "efficiency." Instead, they note that EDM creates an incentive for the merged firm to lower prices. We refer to EDM as an efficiency here because, like other efficiencies, when it exists it is a merger-related change in the market that may theoretically incentivize the merged firm to lower prices. Like all other forms of efficiency, EDM is simply not relevant to the legality of a merger if it does not result in the preservation of competition in the post-merger market, with the assessment of competition not limited to price.

[32] [9] *See, e.g.*, Serge Moresi & Steven C. Salop, *vGUPPI: Scoring Unilateral Pricing Incentives in Vertical Mergers*, 79 ANTITRUST L.J. 185 (2013) (analyzing the incentives created by vertical mergers to increase prices); Marissa Beck & Fiona M. Scott Morton, *Evaluating the Evidence on Vertical Mergers*, 59 REV. IND. ORG. 273 (2021) (compiling studies of the impact of vertical mergers in various industries and observing that half find competitive harm).

bringing antitrust enforcement in line with current economic learning and market realities.[33] . . .

II. THE 2020 VMGS' FOCUS ON EDM IS INCONSISTENT WITH THE STATUTORY TEXT AND MARKET REALITIES.

The Clayton Act prohibits any merger or acquisition that "may" substantially lessen competition in any line of commerce or activity affecting commerce. This is a broad mandate aimed at prohibiting mergers even when they do not constitute monopolization and even when their tendency to lessen competition is not certain. The statute does not distinguish between "horizontal" and "vertical" mergers, nor does it contain exceptions for mergers that lessen competition but also create some form of efficiency.[34] Accordingly, even if a merger does create efficiencies, the statute provides no basis for permitting the merger if it nevertheless lessens competition.[35] Consistent with the statutory language and the Supreme Court's holdings, virtually no cases have relied on an efficiencies defense to permit a merger where that merger might have lessened competition.[36] Cases treating efficiencies that might lower prices as potentially offsetting a merger's lessening of competition generally followed the lead of the DOJ's 1982 and 1984 Guidelines, which suggested that approach.

The 2020 VMGs contravene the text of the statute, devoting a whole section to the discussion of procompetitive effects, or efficiencies, of vertical mergers. This approach is legally flawed because the statute does not provide for a balancing test where an "efficient" merger is allowed even if it may lessen competition. Many "efficiencies" simply make the merged firm more profitable, without affecting the level of competition in the market.[37] Yet under the statute, efficiencies are only relevant insofar as they shed light on the level of post- merger competition, which must be considered across many dimensions—price, quality, innovation, variety, service, and more.[38]

The VMGs' emphasis on a non-statutory efficiency defense leads to their most significant flaw—their treatment of the elimination of double marginalization (EDM). The VMGs identify EDM as the principal reason to treat vertical mergers distinctly from horizontal mergers, claim that EDM "often" causes vertical mergers to benefit consumers, and suggest the agencies will

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[33] [10] Steven C. Salop, *Invigorating Vertical Merger Enforcement*, 127 YALE L.J. 1962, 1983 (2018) (noting that "[t]he 1984 Non-Horizontal Guidelines are out-of-date" and compiling citations).

[34] [12] *Brown Shoe Co. v. United States*, 370 U.S. 294, 344 (1962), *FTC v. Procter & Gamble Co.*, 386 U.S. 568, 580 (1967); *U.S. v Phila. Nat'l Bank*, 374 U.S. 321, 371 (1963); *FTC v. Penn State Hershey Medical Center*, 838 F.3d 327, 347-48 (3d Cir. 2016) (discussing an efficiencies defense and noting that the Supreme Court has "cast doubt on its availability"); Robert H. Lande, *Wealth Transfers as the Original and Primary Concern of Antitrust: The Efficiency Interpretation Challenged*, 34 HASTINGS L. J. 65, 134 (1982).

[35] [13] *See, e.g., Saint Alphonsus Medical Center-Nampa v. St. Luke's*, 778 F.3d 775, 790 (9th Cir. 2015) ("We remain skeptical about the efficiencies defense in general and about its scope in particular."); *U.S. v. Anthem, Inc.*, 855 F. 3d 345, 353, 355 (D.C. Cir. 2017) (observing that "it is not at all clear that [efficiencies] offer a viable legal defense to illegality under Section 7" but considering claimed efficiencies in assessing the merger's impact on competition). There is also significant debate as to what types of "efficiencies" should be cognizable under the antitrust laws. *See, e.g., id.* at 369 (Millet, concurring) (rejecting a claimed efficiency because "securing a product at a lower cost due to increased bargaining power is not a procompetitive efficiency when doing so simply transfers income from supplier to purchaser without any resource savings").

[36] [14] *See* Herbert Hovenkamp, *Appraising Merger Efficiencies*, 24 GEO. MASON L. REV. 703, 704 (2017) ("efficiency claims … are often raised but almost never found to justify a merger that has been shown to be prima facie unlawful. The decisions that credit claimed efficiencies as justification typically also find that the government failed to make out its prima facie case against the merger.").

[37] [17] Moreover, in many cases the predicted efficiencies simply never materialize. For example, AT&T claimed that it would be incentivized by the cost savings of its merger with DirecTV to deploy broadband to more than 13 million households by 2019, but so far has only deployed broadband to 3 million households.

[38] [18] *Saint Alphonsus Medical Center-Nampa v. St. Luke's*, 778 F.3d 775, 790 (9th Cir. 2015) ("The [Clayton] Act focuses on 'competition,' so any defense must demonstrate that the prima facie case portrays inaccurately the merger's probable effects on competition. In other words, a successful efficiencies defense requires proof that a merger is not, despite the existence of a prima facie case, anticompetitive.").

proactively evaluate its impact even when not substantiated by the parties. EDM is cited as a reason to discount both a merger's impact on pricing power and the likelihood of coordination among the remaining firms.

The VMGs' reliance on EDM is theoretically and factually misplaced. It is theoretically flawed because the economic model predicting EDM is limited to very specific factual scenarios: mergers that involve one single-product monopoly buying another single-product monopoly in the same supply chain, where both charge monopoly prices pre-merger and the product from one firm is used as an input by the other in a fixed-proportion production process.[39] Yet outside this limited context, economic theory does not predict that EDM will create downward pricing pressure.[40]

Empirical evidence suggests that we should be highly skeptical that EDM will even be realized—let alone passed on to end-users.[41] In many cases, vertical integration does not even prompt firms to provide the upstream input to its own downstream division.[42] Studies of mergers between hospitals and physician groups—which have led to significant concentration in many areas[43]—suggest these vertical mergers have not achieved theorized efficiencies. Instead, they find that vertical consolidation has increased physician costs, hospital prices, and per capita medical spending, with larger effects in more concentrated markets.[44] Nor have these cost increases been associated with improved medical care.[45] Similarly, when AT&T acquired DirecTV, it successfully argued to the FCC that the merger would lead to downward pricing pressure due to EDM. Yet shortly after the merger, AT&T began raising prices instead.

Withdrawing from the VMGs reflects the FTC's view that it is inappropriate for the Commission's analysis of whether a transaction may lead to a substantial lessening of competition to assume that EDM is likely to exist.

III. THE FTC'S REVIEW OF ITS GUIDELINES WILL CONSIDER MARKET STRUCTURE, REMEDIES, AND ADDITIONAL MECHANISMS OF HARM.

a. The FTC will assess potential market structure-based presumptions for non-horizontal mergers.

Antitrust law, as understood by both the FTC and courts, has long recognized that certain familiar practices have such a clear tendency to harm competition that they should be presumptively or even *per se* illegal. Identifying certain practices as presumptively illegal gives clear guidance to businesses and streamlines enforcement to curb the worst abuses. Moreover, bright-line rules focus judicial attention on readily observable market characteristics rather than complex economic modeling and self-interested testimony about future business plans. The FTC

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[39] [23] John Kwoka & Margaret Slade, *Second Thoughts on Double Marginalization*, 34 ANTITRUST 51 (2020).

[40] [24] *Id.* at 55 ("the classic EDM model is based on a long list of assumptions that do not necessarily hold").

[41] [25] Jonathan B. Baker et al., Comment Letter No. 21 on #798, at 32-34 (Feb. 24, 2020), https://www.ftc.gov/system/files/attachments/798-draft-vertical-merger-guidelines/vmg21_baker_rose_salop_scott_morton_comments.pdf; John Kwoka & Margaret Slade, *supra* note 23, at 56; Alliance for Pharm. Compounding et al., Comment Letter No. 46 on #798, at 2 (Feb. 26, 2020), https://www.ftc.gov/system/files/attachments/798-draft-vertical-merger-guidelines/02-26-20_joint_pharmacy_stakeholder_comments_-_ftc_doj_draft_vertical_merger_guidelines.pdf (citing FTC analysis and other analysis of vertical healthcare consolidation leading to price increases); *see also* Salop, *supra* note 10, at 1970-71("Claims that EDM must lead to lower downstream prices are overstated for several reasons.").

[42] [26] Baker et al., *supra* note 25, at 18-20 ("evidence from a large data base of vertically integrated firms indicates there were no internal input transfers from the upstream division to the downstream division in about half of all the vertically-integrated firms studied" (citing Enghin Atalay et al., *Vertical Integration and Input Flows*, 104 AM. ECON. REV. 1120, 1127 (2014)).

[43] Thomas L. Greaney, *The New Health Care Merger Wave: Does the "Vertical, Good" Maxim Apply?* 46 J. L. MED. & ETHICS 918, 922 (2018).

[44] [28] *Id.*

[45] [29] *Id.*

has reviewed many vertical mergers, providing a significant body of learning that could likewise identify common characteristics of mergers that are presumptively anticompetitive.

Market structure screens have been used for decades by agencies when assessing whether horizontal mergers merit a presumption of anticompetitive effects. Since the 1980s, however, vertical mergers have not been subject to similar screens that use readily-observable market features. This distinct analytical approach to horizontal and vertical mergers is not justified: vertical mergers involving concentrated markets likewise have a structural tendency to harm competition.[46] Commenters suggested numerous candidate screens that pick out mergers deserving of additional focus—or a presumption of illegality—based on a variety of market characteristics.[47] In reviewing our approach to merger analysis, we will seek to identify objective factors that presumptively indicate that a merger is likely to reduce competition.

The 2020 VMGs focus exclusively on the merged firm's incentives to engage in certain general types of practices, such as foreclosing rivals, raising rivals' costs, or misuse of competitively sensitive information. These are all important mechanisms by which vertical mergers can lessen competition. However, the FTC's ability to conduct the analyses contemplated by the VMGs in an individual case depends not only on the availability of adequate data, but also on the FTC's ability to predict in advance all the specific tactics the merged firm might use to disadvantage its competitors with its newfound resources.[48] Identifying and analyzing individual exclusionary tactics is challenging even when considering only current market conditions, given that "'[a]nticompetitive conduct' can come in too many different forms, and is too dependent upon context, for any court or commentator ever to have enumerated all the varieties."[49] It is even more challenging when we know that the affected market will change over time, meaning that the specific costs and benefits of exercising the merged firm's increased market power using a given tactic will vary. Indeed, the fundamental difficulty of predicting all possible forms of exclusionary conduct in advance is one of the reasons why the agencies have traditionally preferred structural to behavioral remedies.[50]

Accordingly, where we have evidence that a particular market structure tends to lessen competition, seeking instead to predict which specific mechanism will lead to that lessening of competition in a specific case may come at great expense with no improvement in our predictive accuracy. The FTC will therefore explore clear and administrable guidance on the characteristics of transactions that are likely unlawful. Such guidance should provide market participants with clear notice, reduce burdens on antitrust enforcers, and aid judges by allowing them to focus on observable facts that tend to predict anticompetitive effects rather than on complex and speculative claims. Use of such screens can streamline enforcement in cases where economic learning suggests the merger may substantially lessen competition, and developing these screens will be a key goal of future guidance.

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[46] [34] Salop, *supra* note 10, at 1973 ("Consider first the well-understood and accepted notion that there is inherent upward pricing pressure from horizontal mergers in differentiated products markets, even without coordination. In fact, the same inherent upward pricing pressure occurs for vertical mergers in similar market structures.").

[47] [35] Jonathan B. Baker et al., *Five Principles for Vertical Merger Enforcement Policy*, 33 ANTITRUST 12, 19 (2019) (proposing five circumstances that should give rise to a presumption of anticompetitive effects for vertical mergers).

[48] [36] *See, e.g.*, Salop, *supra* note 10, at 1979 (advocating use of numerous quantitative analyses of a vertical merger's likely effects, but also noting that "[a]ll these quantitative methodologies also are limited because they generally focus only on a subset of the possible harms that are easiest to quantify with available data. . .").

[49] [37] *Caribbean Broad. Sys., Ltd. v. Cable & Wireless PLC*, 148 F.3d 1080, 1087 (D.C. Cir. 1998).

[50] [38] DEP'T OF JUST., MERGER REMEDIES MANUAL, at 4 (Sept. 2020) (conduct remedies "require the merged firm to ignore the profit-maximizing incentives inherent in its integrated structure. Moreover, the longer a conduct remedy is in effect, the less likely it will be well-tailored to remedy the competitive harm in light of changing market conditions. Conduct remedies typically are difficult to craft and enforce. For these reasons, conduct remedies are inappropriate except in very narrow circumstances"), https://www.justice.gov/atr/page/file/1312416/download; DEP'T OF JUST., ANTITRUST DIVISION POLICY GUIDE TO MERGER REMEDIES, at 7-8 (Oct. 2004), https://www.justice.gov/atr/page/file/1175136/download.

b. The FTC will assess appropriate remedies for non-horizontal mergers.

Going forward, it will be critical for the FTC to evaluate past remedy practices and engage with evidence that its remedies may not have fully restored competition.[51] The FTC's 2017 merger retrospective is part of a tradition of self-reflection at the FTC, and the FTC will continue to scrutinize its past enforcement actions on an ongoing basis. Providing clear guidance on when remedies are unlikely to be effective will help identify scenarios where a challenge is more likely than settlement. Identifying such scenarios may deter such mergers and avoid the wasted resources associated with their attempt.

c. The FTC will assess prevalent harms that may result from non-horizontal mergers.

The 2020 VMGs identified several harms that can arise from non-horizontal mergers, including the potential for foreclosure, raising rivals' costs, increased entry barriers, and misuse of competitively sensitive information. They did not purport to be exhaustive, and no list of potential harms could have been. Our merger policy review will expand on the work done in 2020 to consider various features that often characterize firms in the modern economy, including in digital markets. We will also look to provide guidance on how the FTC will analyze a merger's impact on labor markets.

Digital platforms are an increasingly significant part of the economy. The five largest firms in the United States by market capitalization all operate digital platforms characterized by significant network externalities, and collectively they have made hundreds of acquisitions, including hundreds of acquisitions that fell below the HSR reporting thresholds. It is critical that the FTC establish a framework for merger analysis that accounts for features specific to digital markets, including characteristics that can enable dominant firms to capture markets and dissuade entry, as well as non-price effects.[52] For example, markets with network effects can create a strong incentive to acquire or exclude nascent competitors, a tendency that should be considered when dominant platforms acquire start-ups.[53] Additionally, the fact that digital markets may enable firms to engage in myriad forms of non-price discrimination—for example, thorough degrading interoperability, reneging on access policies, or gaming algorithms—means that revised guidelines should pay greater attention to the broader set of tactics that firms may use to raise rivals' costs,[54] as well as the impact of an acquisition on competitors' access to capital.[55]

Finally, a process to revise the guidelines should consider harms in labor markets, a topic not previously addressed in merger guidelines.[56] Section 7 prohibits mergers that will lessen competition "in any line of commerce or in any activity affecting commerce," which extends beyond

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[51] [39] *See, e.g.*, JOHN E. KWOKA, MERGERS, MERGER CONTROL, AND REMEDIES: A RETROSPECTIVE ANALYSIS OF U.S. POLICY (MIT Press, 1st ed. 2015); Fernando Luco & Guillermo Marshall, *Vertical Integration with Multi-Product Firms: When Eliminating Double Marginalization May Hurt Consumers* 1, 15 (Oct. 20, 2017) (unpublished manuscript), http://www.ftc.gov/system/files/documents/public_events/1208143/luco_marshall.pdf (offering evidence that Coca-Cola and PepsiCo bottler acquisitions raised prices of Dr. Pepper Snapple products, while reducing prices of Coca-Cola and PepsiCo products).

[52] [44] The VMGs correctly acknowledge that non-price elements of competition such as product quality and innovation must be considered, but did not provide a framework for how these non-price factors would be assessed, instead highlighting quantitative models of price effects.

[53] [45] Platform issues are present in many markets, not just digital ones, including healthcare markets (e.g., insurance networks, pharmacy benefits manager networks), payments, and many others. *See* NON-HSR REPORTED ACQUISITIONS BY SELECT TECHNOLOGY PLATFORMS, 2010- 2019: AN FTC STUDY.

[54] [46] The 2020 VMGs recognized that a merged firm may have an incentive to raise rivals' costs and that it may do so by degrading quality, but this topic is worth significant additional attention.S

[55] [47] Indeed, some venture capitalists refer to a "kill zone": an area where firms that might compete with extremely large companies cannot obtain funding. Sai Krishna Kamepalli et al., *Kill Zone* (Becker Friedman Inst., Working Paper No. 2020-19), https://ssrn.com/abstract=3555915.

[56] [48] Jose Azar et al., *Labor Market Concentration*, 56 J. OF HUM. RESOURCES 1, 5 (2020).

the scope of the products and services sold by the merging parties to include other markets affected, such as labor markets. Because labor market analysis in merger review would be novel, the FTC, merging parties, and courts would benefit from a clear framework for evaluating these common issues.

IV. LOOKING AHEAD

The FTC will work with the Department of Justice to seek input and review evidence on the effectiveness of prior enforcement practices. It is critical that our enforcement program comprehensively captures the relevant harms that may arise from transactions, uses our substantial experience to identify appropriate bright-line screens for unlawful mergers, and carefully and continuously reviews empirical learning. Based on that review, the FTC will issue updated guidelines or rules to ensure our merger analysis aligns with market realities. In the interim, the Commission will rely on its statutory authority to apply existing laws when assessing proposed transactions.

■ **Dissenting Statement of Commissioners Noah Joshua Phillips and Christine S. Wilson** . . . .

The Majority's Decision Will Chill Procompetitive Deals and Hurt Consumers

Section 7 of the Clayton Act, the main U.S. law governing mergers, bars transactions where "the effect may be substantially to lessen competition". Vertical mergers are *not* mergers of competitors. Rather, they combine firms that are in a buyer-seller relationship. Suppose a company that specializes in manufacturing only smartphones merges with a company that specializes in manufacturing only smartphone chips, some of which it was selling to the smartphone manufacturer. That is a vertical merger. It does not directly eliminate competition, as the companies were not competing (or about to compete) with each other before they merged.

Vertical integration is a common "make or buy" phenomenon similar to choices that consumers make daily—it's one way that companies grow. When considering what to have for dinner, a consumer may choose to outsource food preparation by eating at a restaurant or getting take-out; alternatively, he may rely on groceries in his refrigerator and pantry to make dinner himself. When discovering a leak in her home, a consumer can outsource the repairs by hiring a plumber; alternatively, a handy consumer may fix the leak herself.

One immediate and positive effect of a vertical merger is that transactions (*e.g.,* chip sales) that were occurring at arm's length in the market now take place within the merged firm. As a consequence, the merged firm is no longer paying a markup on the product it is now supplying to itself (*e.g.,* smartphone chips), a phenomenon that economists call the "elimination of double marginalization". The merged firm benefits from a lower manufacturing cost for each unit it produces (*e.g.,* each smartphone), allowing it to compete more aggressively by lowering its price and selling more units, and leaving consumers better off. Vertical mergers can also increase efficiency and competitiveness in other ways, like saving the substantial time and money that often go into finding reliable trading partners, negotiating terms of sale, coordinating R&D and product design, and writing contracts that cover multiple contingencies but can never capture them all. . . .

Not all vertical mergers are benign. Some may harm competition and consumers. The 2020 Guidelines describe how such harm can occur and the framework that the FTC and DOJ have developed, over decades of experience, to analyze both the anti- and procompetitive effects of vertical mergers. Contrary to decades of established case law, the Majority claim that the 2020 Guidelines "contravene the text of the statute" by recognizing the "procompetitive effects, or efficiencies, of vertical mergers." The Majority commits two flaws in its analysis. First, they

conflate procompetitive effects of a merger with merger efficiencies.[57] Second, they ignore the burden shifting framework adopted by the circuit courts recognizing that procompetitive effects may render a competition-eliminating merger procompetitive on the whole.[58] Similarly, a successful efficiency defense, *i.e.,* that the proposed merger's efficiencies would likely offset the merger's potential harm to consumers, is sufficient to save a merger. That said, Guidelines have long counseled skepticism, which is routinely applied. But the fact remains that vertical mergers are different animals from mergers of competitors, changing incentives in ways that are, on the whole, more likely to improve efficiency, bolster competition, and benefit consumers.[59] As such, they require an approach that fully accounts for their good as well as their bad effects. Anything less will hurt consumers, not help them.

The Majority Discards Transparency in Favor of Uncertainty

The 2020 Guidelines marked an important development in U.S. merger enforcement and provided needed transparency into the agencies' evaluation of vertical (and other non-horizontal) mergers. They are well founded, based on accepted economic principles, reflect precedent from courts and the agencies, and were the result of robust public comment….

The Majority Prefers Unchecked Regulatory Power Over Guidance

… The majority could have waited to rescind the 2020 Guidelines until they had something with which to replace it. It appears they prefer sowing uncertainly in the market and arrogating unbridled authority to condemn mergers without reference to law, agency practice, economics, or market realities. The public and Congress should be alarmed by the majority's repeated withdrawal of existing guidance and transparency in favor of an amorphous bureaucratic fog that will provide cover for those who seek to politicize antitrust….

NOTES AND QUESTIONS ON THE 2020 VERTICAL MERGER GUIDELINES AND THEIR WITHDRAWAL

The 1984 Guidelines had addressed only concerns about outright foreclosure and facilitating oligopolistic coordination. In addition to updating guidance on those issues, the 2020 Guidelines added guidance on assessing the concern that the merged firm might worsen the availability, price or quality of a product in order to raise rival costs in way that would divert sales of another product from those rivals to the merged firm. Further, the 1984 Guidelines were limited to strictly vertical mergers: i.e.,

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[57] [10] VMGs ("The elimination of double marginalization is not a production, research and development, or procurement efficiency; it arises directly from the alignment of economic incentives between the merging firms. Since the same source drives any incentive to foreclose or raise rivals' costs, the evidence needed to assess those competitive harms overlaps substantially with that needed to evaluate the procompetitive benefits likely to result from the elimination of double marginalization.").

[58] [11] *See* Otto Bock HealthCare North America, Inc., 2019 WL 5957363, at *33-35 (F.T.C. Nov. 1, 2019) (opinion authored by Comm'r Rohit Chopra); United States v. AT&T, Inc., 310 F. Supp. 3d 161 (D.D.C. 2018); FTC v. H.J. Heinz Co., 246 F.3d 708 (D.C. Cir. 2001); United States v. Baker Hughes Inc., 908 F.2d 981, 982 (D.C. Cir. 1990); ProMedica Health Sys. v. FTC, 749 F.3d 559, 571 (6th Cir. 2014); FTC v. H.J. Heinz Co., 246 F.3d 708, 720-22 (D.C. Cir. 2001); FTC v. Tenet Health Care Corp., 186 F.3d 1045, 1054-55 (8th Cir. 1999); FTC v. Univ. Health, Inc., 938 F.2d 1206, 1222–24 (11th Cir. 1991).

[59] [12] *See* ... Francine Lafontaine & Margaret Slade, Vertical Integration and Firm Boundaries: The Evidence, 45 J. ECON. LIT. 629, 680 (2007) (conducting a broad study of past vertical integrations and concluding "even in industries that are highly concentrated . . . , the net effect of vertical integration appears to be positive in many instances"); Cooper, Froeb, O'Brien, & Vita, supra note 20, at 658 ("Most studies find evidence that vertical restraints/vertical integration are procompetitive" and "[t]his efficiency often is plausibly attributable to the elimination of double-markups or other cost savings."); Global Antitrust Institute, Antonin Scalia Law Sch., Geo. Mason Univ., Comment Submitted in the Federal Trade Commission's Hearings on Competition and Consumer Protection in the 21st Century, Vertical Mergers, at 5-9 (filed Sept. 6, 2018) (summarizing the available empirical studies and concluding that either nine or ten of the eleven studies "indicated vertical integration resulted in positive welfare changes" or "no change" in welfare); David Reiffen and Michael Vita, Is There New Thinking on Vertical Mergers? A Comment, 63 ANTITRUST L.J. 917 (1995) (arguing the economics suggests the vast majority of vertical mergers are efficiency-enhancing); Michael H. Riordan & Steven C. Salop, Evaluating Vertical Mergers: Reply to Reiffen and Vita Comment, 63 ANTITRUST L.J. 943, 944 (1995) (agreeing with Reiffen and Vita that "efficiency benefits provide the rationale for many vertical mergers, can lead to increased competition and consumer welfare, and are sufficient to offset potential competitive harms in many cases").

between firms in same supply chain. The 2020 Guidelines also addressed diagonal mergers (in which the firm acquires an input used by rivals but not by merged firm) and mergers of complements (which are products jointly used by buyers). For complements, the anticompetitive concern is that the merged firm might worsen terms for one complement unless buyers take the merged firm's other complement.

The 2020 Guidelines state that HHIs or market shares may be relevant, but they do not use thresholds based on them to assess the likelihood of anticompetitive effects. Instead, the 2020 Guidelines directly examine the likelihood of anticompetitive effects and efficiencies in each case. The Guidelines stress that the likelihood of anticompetitive effects from worsening terms for one product depend on the merged firm's (a) ability to cause rival to lose significant sales in another market by doing so and (b) incentive to do so, which requires that it would gain more profits in that market than it would lose in the market in which its product terms would be worsened. The Guidelines also stress that vertical mergers often have the efficiency of eliminating double marginalization.

1. Should the FTC majority have withdrawn the 2020 Guidelines' assessment of anticompetititve effects*?* The FTC majority stressed that the 2020 Guidelines were a major improvement over the 1984 Guidelines and provided important principles for assessing anticompetitive effects. The majority's major objection seemed to be the Guideline's assessment of efficiencies. Should the majority have just withdrawn the parts of the Guidelines that assessed efficiencies, while leaving the rest in place as useful guidance until it could replace them?

2. Is the FTC majority right that the 2020 Guidelines' assessment of anticompetitive effects should include an approach that is presumptively based on market shares and concentration? The 2020 Guidelines declined to rely on presumptions based on market shares and concentration in part because low levels of them are not inconsistent with anticompetitive effects. Even if that is so, might one be able to presume anticompetitive effects when market shares and concentration are high? Would such a structural approach lead to better results on average than case-by-case analysis of the likely effects? Would courts draw the incorrect inference from such thresholds that anticompetitive effects were implausible when market shares and concentration were low?

3. Is the FTC majority right that efficiencies are generally irrelevant? The majority takes the position that efficiencies are "simply not relevant to the legality of a merger if it does not result in the preservation of competition in the post-merger market." Majority Statement n.8. However, the majority does not make clear what it means by preserving "competition." If an efficient vertical merger would lower prices but also likely drive one of ten downstream firms out of the market, does the merger fail to preserve competition (because it reduces the number of competitors from ten to nine) or instead enhance competition (because there are still nine competing firms and the efficiency makes them compete more vigorously in a way that lowers prices)? There is a deep ambiguity about the meaning of the word "competition" that the majority statement never addresses.

4. Is the FTC majority right about its specific critique of the 2020 Guidelines' treatment of the elimination of double marginalization (EDM)? The FTC majority was particularly concerned that the 2020 Guidelines stated that EDM "often" causes vertical mergers to benefit consumers, noting that vertical mergers often cannot be justified by EDM. But could not both statements be true? Although the FTC majority stressed it is wrong to assume that a vertical merger is "likely" to cause EDM, the 2020 Guidelines do not seem to have ever incorporated such an assumption. On the other hand, for reasons discussed in the notes after the *U.S. v ATT* case, it seems problematic that the 2020 Guidelines stated that the agencies would not consider less anticompetitive alternatives to eliminate EDM that were "not reflected in documentary evidence" already.

Insert: Replace Notes and questions section with the following at page 1188.

NOTES AND QUESTIONS ON U.S. GUIDELINES ON MERGERS AFFECTING POTENTIAL COMPETITION

The 1984 U.S. Merger Guidelines embraced theories of both potential and perceived competition in highly concentrated markets. The 2010 Horizontal Merger Guidelines replaced these guidelines on mergers affecting potential competition with a different approach.[60] They simply project a future market share for the potential entrant, and then apply the standard horizontal merger guidelines given those projections. The 1984 Guidelines projected market shares, but only when the likelihood of entry was "particularly strong." The 2010 Guidelines, however, effectively always require strong evidence of likely entry by narrowing who counts as a potential entrant, requiring evidence that the firm either (1) has already "committed" to entry or (2) would very likely enter rapidly in response to a SSNIP without incurring significant sunk costs. Firms already committed to enter seem to correspond to actual potential competition, and firms likely to enter rapidly seem to correspond to perceived potential competition, though on the latter the 2010 Guidelines focus more on actual responsiveness to price increases rather than incumbent perceptions of it. The 2010 Guidelines approach also seems to avoid the 1984 guideline approach of counting how many other firms have similar entry advantages, by simply taking any entry advantages into account in projecting future shares.

1. Should the 2010 Guidelines have replaced the 1984 Guidelines on potential competition? The differences between the 1984 and 2010 Guidelines boil down to the fact that the former would block mergers with potential entrants who have entry advantages possessed by few other firms if they: (a) have not committed to enter but are actually likely to do so; (b) would have to incur significant sunk costs to enter but are likely enough to enter in response to price increases that they would constrain those price increases from ever occurring; (c) are not actually likely to enter in response to price increases, but are wrongly perceived to be likely to do so by incumbents. Should the agencies have stopped pursuing such claims? Note that claims (a) and (b) would be consistent with neutral treatment of defensive and offensive uses of potential entry, because the existence of such potential entrants (if not part of the merger) could be citing by the merging parties defensively under 2010 Guidelines § 9, even though such potential entrants are not quite likely enough to enter to be deemed market participants already.

2. What about eliminating doubly-potential competition? Suppose two firms form a joint venture to enter into a market that neither of them are in now. Can their combination be challenged on the ground that, without their joint venture, either (a) both of them would have entered that market or (b) one would entered and had its pricing constrained by the perception the other might enter too? Both were held to be viable claims in United States v. Penn-Olin Chemical, 378 U.S. 158 (1964), which remains binding law, though it seems unlikely the agencies would bring such a claim today.

Insert: Replace note with the following at page 1210.

When to Block a Merger Based on a Risk of Post-Merger Misconduct

The U.S. agencies have largely abandoned efforts to block mergers based on post-merger misconduct, mainly on the theory that other laws can always deter any post-merger misconduct and should be changed or reinterpreted if they do not. However, as we have emphasized

[60] The 2010 Horizontal Merger Guidelines did not themselves make clear they were replacing (rather than just supplementing) the 1984 Merger Guidelines on mergers affecting potential competition. However, the 2020 Vertical Merger Guidelines now make it clear that all extant sections of the 1984 Guidelines are withdrawn and superseded and that the 2010 Horizontal Merger Guidelines describe the methods that the agencies now use to assess mergers that affect potential competition. *See* U.S. DOJ/FTC, Vertical Merger Guidelines §1 & n.1 (2020).

throughout this book, uncertainties in information and adjudication mean that any rule that regulates conduct optimally cannot eliminate underdeterrence, but rather can only minimize the sum of harm from under-and overdeterrence. Thus, other laws will, even if optimally designed, always leave some bad post-merger conduct underdeterred, raising the question whether it is better to tackle the problem by blocking the merger that creates the ability or incentives to engage in that misconduct.

If efficiency gains from a merger are shown, an agency that wanted to assess whether to block a merger based on the risk of post-merger misconduct would have to determine whether that efficiency exceeds the likelihood of post-merger misconduct times the magnitude of the anticompetitive harm it would create. Thus, the ultimate question is whether:

$$\begin{array}{c}\text{Merger-}\\\text{Specific}\\\text{Efficiency}\\\text{Gain}\end{array} > \begin{array}{c}\text{(Probability}\\\text{Post-Merger}\\\text{Misconduct}\\\text{Is Profitable)}\end{array} \times \begin{array}{c}\text{(Probability}\\\text{Post-Merger}\\\text{Misconduct Will}\\\text{Be Undeterred}\\\text{by Other Laws)}\end{array} \times \begin{array}{c}\text{(Magnitude of}\\\text{Anticompetitive}\\\text{Harm from}\\\text{Post-Merger}\\\text{Misconduct)}\end{array}$$

Although the relevant variables may not be susceptible of precise quantification, this sort of formula usefully helps to frame analysis. In particular, it shows that merger enforcement is more desirable the more likely it is that the feared post merger-conduct will be (1) profitable, (2) undeterred, and (3) anticompetitive.

Indeed, we can use the above formula and 3 factors to map the general pattern of merger enforcement. It makes sense that the areas of most vigorous merger enforcement are blocking mergers that create unilateral or oligopoly effects, because there the bad post-merger misconduct is high unilateral or oligopoly pricing, which is highly profitable, cannot be regulated post-merger, and causes great anticompetitive harm. *See* Chapters 3, 6. Vertical mergers have historically manifested weaker enforcement because the main feared post-merger misconduct has been refusing to deal with rivals, which may not be profitable, is subject to at least some (though fairly deferential) antitrust scrutiny under unilateral refusal to deal doctrine, and may not be that anticompetitive when it occurs. However, increased enforcement seems indicated by the modern focus on how vertical mergers might give merged firms incentives to increase the price of inputs sold to downstream rivals in a way that diverts sales from them and increases the profits of the merged firm's downstream business, given that such pricing behavior is nearly impossible to regulate post-merger with antitrust law and is likely more profitable than outright refusals to sell to rivals. Conglomerate mergers that eliminate potential competition manifest more mixed enforcement because the potential competition may not be profitable and eliminating it may not be that harmful, but any anticompetitive problem cannot be deterred post-merger because there is no effective way to force the merged firm to enter a market and compete with itself. Conglomerate mergers that enable post-merger exclusionary conduct manifest the weakest enforcement because there the feared conduct is vertical exclusionary conduct that may not be profitable, is subject to strictest antitrust scrutiny of any post-merger conduct here discussed, and may not be anticompetitive if it occurs. Not surprisingly, conglomerate mergers that enable post-merger exclusionary conduct have historically been challenged mainly when the post-merger conduct is something relatively hard to regulate, like reciprocity, so more likely to go undeterred.