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FTC Orders Divestiture in Vertical Merger Case, Setting Up Federal Court Appeal

- The Federal Trade Commission recently reversed its administrative law judge and found that Illumina's acquisition of GRAIL was illegal under Section 7 of the Clayton Act. The commission ordered that Illumina divest GRAIL.
- The commission's opinion is notable for its discussion of how the FTC analyzes vertical mergers and proposed deal "fixes," both of which are increasingly coming under scrutiny by the U.S. antitrust agencies.
- Illumina has appealed, presenting an opportunity for a federal court of appeals to weigh in on vertical merger analysis.

In a lengthy opinion made public last week, the FTC, by a vote of 4-0, determined that Illumina's acquisition of GRAIL may substantially lessen competition in a market for the "research, development, and commercialization of MCED [multi-cancer early detection] tests" and ordered Illumina to divest GRAIL. In doing so, the commission overruled its administrative law judge (ALJ), who had earlier found that FTC complaint counsel failed to prove a prima facie case. Illumina has appealed the FTC's decision to the U.S. Court of Appeals for the Fifth Circuit, arguing that the decision "suffers from many flaws -- including that it is unconstitutional, misconstrues the antitrust laws and cherry picks from the administrative record."

Background

In March 2021, the FTC filed an administrative complaint seeking to block Illumina's vertical acquisition of GRAIL. At the time, Illumina owned 14.5 percent of GRAIL's voting shares and proposed to acquire the remainder. GRAIL has developed an MCED test which relies on "next-generation" DNA sequencing (NGS) platforms sold by Illumina. In its complaint, the FTC alleged that Illumina is "a dominant provider of NGS platforms," GRAIL and its competitors "have no substitutes for Illumina's NGS platforms" and the acquisition would harm competition in the market for MCED tests, which had not yet been commercialized. Specifically, the FTC alleged that "Illumina will gain the incentive to foreclose or disadvantage firms that pose a significant competitive threat to GRAIL and to limit the competitiveness of any MCED product" and, as a result, "Illumina will control the fate of every potential rival to GRAIL for the foreseeable future." The theory of harm is one found in the DOJ-FTC vertical merger guidelines, which were rescinded by the FTC in September 2021.

In an attempt to address the FTC's challenge, after the litigation was commenced, Illumina announced that it was "irrevocably offering" a 12-year supply contract, which it said includes terms for "guaranteed access to the latest sequencing products," "no price increases for the sequencing products covered by the agreement" and "guaranteed lower pricing for the sequencing products by 2025." Citing this "open offer," among other things, the FTC ALJ concluded in September 2022 that FTC complaint counsel "failed to prove its asserted prima facie case that Illumina's post-Acquisition ability and incentive to advantage GRAIL to the disadvantage of GRAIL's alleged rivals is likely to result in a substantial lessening of competition in the relevant market for the research, development, and commercialization of MCED tests."

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The procedural journey of the FTC's litigation is notable. When it commenced its administrative proceeding in March 2021, the FTC also sued Illumina in federal court, seeking a preliminary injunction against the acquisition. (This dual-track approach is common for FTC merger challenges because without an injunction or some impediment in another jurisdiction, the parties would be free to merge despite the pendency of an administrative action.) However, in June 2021, the federal court dismissed the complaint at the FTC's request. This allowed the FTC to proceed solely in its "home court." At the time, the FTC asserted that because the European Commission "announced that it has accepted requests from member states to assess Defendants' proposed transaction," the parties could not close the transaction and a preliminary injunction was not necessary to preserve the status quo. But in August 2021, Illumina stated that it "believes that the European Commission does not have jurisdiction to review the merger as the EU merger thresholds are not met, nor are they met in any EU member state" and closed the transaction. The European Commission later prohibited the deal in a decision announced in September 2022, shortly after the FTC ALJ's decision to the contrary. Illumina challenged this, and legal proceedings are ongoing in the EU.

The FTC's Decision

The FTC complaint counsel appealed the decision of the ALJ to the commissioners, who conducted a de novo review of the initial decision's findings of fact and conclusions of law. The commission, in an opinion authored by Chair Lina M. Khan, reversed the initial decision.

Prima facie finding of competitive harm

The commission began by examining whether complaint counsel had established a prima facie case that the acquisition would likely harm competition.

Relevant market. First, the commission agreed with the ALJ that the relevant product market in which to analyze the acquisition's effect was "the research, development, and commercialization of MCED tests." Here, the commission used a common method to define the market – i.e., it looked for "practical indica" that a market existed. These practical indica, which derive from the Supreme Court's 1962 *Brown Shoe* opinion, include: "industry or public recognition of the [market] as a separate economic entity, the product's peculiar characteristics and uses, unique production facilities, distinct customers, distinct prices, sensitivity to price changes, and specialized vendors." Notably, in response to the claim that "GRAIL's rivals are 'years away' from launching an MCED test," the commission wrote that this "may have relevance for defining a relevant market for existing MCED tests," but "miss[es] the mark for a market defined around the research, development, and commercialization of such tests," which is the market posited by the FTC. According to the opinion, the applicable question is "whether MCED tests will be sufficiently interchangeable in the future such that the merged firm has an incentive to disadvantage GRAIL's rivals as they pursue research, development, and commercialization." The commission found that the "balance of evidence shows that they will." The commission also found that several companies were engaged in "current competition in the research and development of MCED tests."

***Related Product*.** The commission then determined that Illumina's NGS platforms were a "critical input" for developers of MCED tests. It also found that "Illumina is the only viable supplier of the critical NGS inputs on which MCED developers depend," after finding, in line with the ALJ's decision, that other companies' NGS platforms were "insufficient, either because they lack characteristics essential for MCED test development, or because they will not become available to MCED test developers in the United States within a reasonable time frame, or both." Notably, the commission's opinion stated that it was not necessary for complaint counsel to "demonstrate that NGS is a relevant product market," only to show that "Illumina's NGS platform is a critical input for MCED developers."

Competitive effects analysis. After the threshold relevant market and critical input determinations, the commission turned to analyze the potential competitive effects of the transaction using "two different but overlapping standards for evaluating the likely effect of a vertical transaction." Here, the commission first looked at competitive effects using the framework from the 1962 *Brown Shoe* case, which involves an examination of "the share of the market foreclosed" and other factors. (According to *Brown Shoe*, "the diminution of the vigor of competition which may stem from a vertical arrangement results primarily from a

foreclosure of a share of the market otherwise open to competitors," but that in many cases where foreclosure is not "of monopoly . . . proportions . . . it becomes necessary to undertake an examination of various economic and historical factors.")

The commission acknowledged, however, that "[m]ore recently, courts and enforcers have focused on whether a transaction is likely to increase the ability and/or incentive of the merged firm to foreclose rivals from sources of supply or from distribution outlets." Commissioner Wilson, who has since resigned, did not join the part of the commission opinion that analyzed competitive effects under *Brown Shoe*, writing that "there is no '*Brown Shoe* standard' in modern antitrust analysis." She nevertheless joined with the other commissioners in finding that a prima facie case was established using "the ability and incentive approach to analyzing foreclosure."

Using *Brown Shoe*, the commission found "that at least four of the factors" from that case "support a finding of a violation here." These are: "likely foreclosure, the nature and purpose of the transaction, the degree of market power possessed by the merged firm, and entry barriers." With respect to likely foreclosure, the commission found that "Illumina is currently, and for the reasonably near future will remain, the only viable supplier of a critical input: NGS platforms necessary for MCED tests." The commission also found that Illumina's "dominance is sustainable" given the lack of adequate alternative NGS platforms; and that "MCED developers' dependence on Illumina's NGS platforms renders them susceptible to foreclosure," which Illumina could do by raising their NGS-related costs or withholding access to supplies, service or "new or improved NGS products," among other things. "Consequently," the commission wrote, "the share of the market that may be foreclosed is very substantial." The commission went on to find, in a heavily redacted part of the opinion, that the "nature and purpose of the transaction," the merged firm's market power, and entry barriers also supported the prima facie case. The opinion noted that "the nature of the transaction is a sole-source supplier taking full ownership of a downstream customer."

The commission also analyzed the transaction under the "different but overlapping standard" of vertical merger harm: whether Illumina would have the ability and incentive to harm GRAIL's rivals. According to the commission, "[t]o harm competition, a merger need only create or augment either the combined firm's ability or its incentive to harm competition. It need not do both." In this case, the commission found that Illumina had the ability to harm MCED test developers given its position as "the dominant provider of NGS," and the acquisition increased its incentive to do so. Among other things, after the merger, "Illumina will directly benefit from tilting the innovation race in favor of GRAIL, the MCED provider that it now 100% owns" because it will now earn margin on the sale of GRAIL tests.

Rebuttal case

After finding that FTC complaint counsel had established a prima facie case that the transaction would likely harm competition, the commission weighed the parties' arguments that the anticompetitive effects established by complaint counsel would be overcome by Illumina's "open offer" to supply NGS, market entry by other firms, deal-related efficiencies and procompetitive benefits. The commission determined that Illumina failed to rebut the prima facie case.

According to the commission, "[t]o serve as a plausibly effective remedy, the Open Offer would need to foresee and foreclose all possible ways Illumina could harm GRAIL's competitors." The commission, however, found fault with several aspects of the open offer, ultimately concluding that it "would not restore the pre-Acquisition level of competition" because "it does not eliminate Illumina's ability to favor GRAIL and harm GRAIL's rivals, . . . does not fundamentally alter Illumina's incentives to do so, . . . does not replicate the cooperation Illumina would have been incentivized to provide to third-party MCED test developers absent the Acquisition, and it would not replace the competitive intensity that existed before the Acquisition."

The commission also concluded that "claims of efficiencies" – including R&D efficiencies and acceleration of the time to bring MCED tests to market – "are inadequate" because, among other things, they are unverified, are "not merger-specific" and "not likely to benefit the public."

Significance

Return to *Brown Shoe* for vertical mergers? Here, the FTC's reliance on *Brown Shoe* did not impact the ultimate outcome of the case. The commission concluded that the merger was likely to harm competition using either *Brown Shoe* or incentive/ability analysis. However, if *Brown Shoe* were to be used in future vertical merger analysis, for example by being incorporated into the forthcoming revision of the DOJ-FTC merger guidelines, it could have consequences for merger enforcement. In general, *Brown Shoe* was more skeptical of vertical mergers than most current economic theory is. Ultimately, of course, it is up to courts or Congress to determine how vertical mergers are to be judged.

Consideration of "fix." In this case, the commission declined to consider the open offer "fix" at the prima facie case stage, where the burden would have been on the FTC complaint counsel to establish that the transaction, including the open offer, may lessen competition. Instead, the commission considered the open offer at the rebuttal stage, where the burden is on the deal parties to overcome the likely anticompetitive effects established at the prima facie stage.

The treatment of "fixes" is very much a live issue in merger enforcement. In particular, agencies and deal parties have recently differed over whether courts should analyze proposed deal fixes in the prima facie case, in rebuttal or as a remedy after finding of liability. In the recent UnitedHealth-Change Healthcare case, the judge suggested, contrary to the DOJ's position, that the parties' proposed fix (a divestiture) should be analyzed at the prima facie stage. And the judge in the DOJ's pending challenge to the Assa Abloy-Spectrum Brands deal is weighing how she should evaluate a proposed divestiture fix. The DOJ argues that it should be considered at the remedy stage.

There are significant practical implications for how fixes are considered. If a proposed fix is considered only after a prima facie case has been made, the government may initially have an easier time satisfying its initial burden to show likely anticompetitive effects, and deal parties would have to show that the fix would overcome the likely anticompetitive effects. In such a situation, deal parties may find it strategically beneficial to "fix it first" – that is, structure their deal with divestitures already in place.

Issues that may be dealt with on appeal. Illumina's decision to appeal the commission's action is notable for several reasons. First, it will provide a federal court of appeals the opportunity to weigh in on vertical merger analysis. Appeals in merger cases are rare, and vertical merger cases are rarer still – though they are coming under increased scrutiny by U.S. antitrust enforcement agencies, with mixed results. In recent years, the Department of Justice lost two vertical merger challenges in the courts (AT&T-Time Warner and UnitedHealth-Change Healthcare). However, several other vertical deals were abandoned by the parties in the face of government challenges, but those challenges were not litigated to judgment in court.

Additionally, depending on the arguments put forward in the appeal, the court may have occasion to address several constitutional questions: in the administrative proceeding, Illumina raised defenses based on the FTC's structure, as well as due process and equal protection concerns.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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