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Regulatory Focus on Vertical Mergers May Impact Investor Exit Strategy Planning

- Antitrust enforcers are expected to increase their scrutiny of vertical mergers. As a result, some vertical deals may be subjected to lengthier investigations.
- Because vertical mergers are a frequent exit strategy for private equity sponsors, investors and their advisors should weigh the regulatory risks of various exit options, as these risks may impact a potential deal's timing and overall chance of success.
- A current FTC vertical merger challenge may provide insight on the viability of a strategy in which the merging parties unilaterally offer a conduct remedy in order to address competitive concerns.

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Background

Vertical mergers – those involving companies at different levels of the supply chain – are the subjects of increasing regulatory scrutiny by antitrust enforcement agencies. For much of the recent past, these acquisitions have largely been viewed as pro-competitive for various reasons and have rarely been subject to regulatory challenges in the United States (some non-US competition agencies have been more aggressive toward vertical mergers than US enforcers). Indeed, the US agencies' current Vertical Merger Guidelines, adopted in mid-2020, recognize that "vertical mergers often benefit consumers" and state that vertically integrated firms may "be able to create innovative products in ways that would not likely be achieved" otherwise. At the same time, the guidelines also recognize competitive harms that could arise from certain vertical integrations, including that in certain circumstances they could deter innovation by raising an innovator's costs of inputs.

Two current members of Federal Trade Commission (FTC), including the acting chair, have expressed concerns that the Commission "has allowed decades of vertical consolidation to go uninvestigated and unchallenged." Acting Chair Rebecca Kelly Slaughter, who voted against the release of the vertical guidelines, has called for more aggressive investigation of vertical mergers and, ultimately, more aggressive challenges to these deals. She has urged the FTC to take on "more litigation risk" and to be concerned more with "false negatives of under-enforcement" than with "false positives of over-enforcement." Ultimately the antitrust agencies are constrained by the courts, as much of the extant case law is not favorable for the government to mount successful challenges to vertical mergers.

The majority of vertical deals will likely not present competitive concerns and will not attract lengthy agency investigation. However, for certain deals at the margins, if a more aggressive stance toward vertical merger enforcement becomes the majority view at the FTC, we can expect challenges to or extended review of some deals that in the past may have avoided regulatory scrutiny or at least been allowed to proceed with modifications or conditions.[1] An enforcement agenda which devotes more resources to vertical merger investigations and views such deals with increased skepticism could have important consequences for private equity sponsor exit strategies, which often involve vertical acquisitions of earlier-stage companies by more established companies.

To be sure, successful challenges to block vertical deals have been exceedingly rare. Notably, in 2017, the U.S. Department of Justice lost its lawsuit seeking to enjoin AT&T's acquisition of Time Warner in 2017. However, the agencies have required deal modifications in several vertical deals. For example, the FTC agreed to behavioral remedies for Northrup Grumman's acquisition of Orbital ATK in 2018[2] and Staples' acquisition of Essendant in 2019.[3]

The FTC Challenges a Vertical Merger

After a long period marked by the absence of vertical merger challenges, on March 30, 2021, the FTC announced that it commenced litigation before the Commission and in federal district court challenging Illumina, Inc.'s proposed acquisition of Grail, Inc.

According to the FTC's complaint, Illumina is "the dominant provider of DNA sequencing" and Grail is developing a multi-cancer early detection (MCED) test, a liquid biopsy which relies on DNA sequencing to detect DNA from cancer cells present in the bloodstream. Illumina, which founded Grail, currently owns 14.5 percent of Grail's voting shares and is seeking to acquire the remainder of the shares from Grail's other investors.

The FTC alleges that Grail and its competitors "have no substitutes for Illumina's NGS's [next-generation sequencing] platforms" and that if the acquisition were allowed to proceed it would harm competition in the not yet commercialized market for MCED tests. The FTC argues that "Illumina will gain the incentive

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1 President Biden has announced his intention to nominate Lina Kahn to the Commission. She has written about a more aggressive approach to vertical integration. *See* Lina M. Kahn, Amazon's Antitrust Paradox, 126 Yale L.J. 710 (2017).

2 The FTC required the merged firm to "make its solid rocket motors and related services available on a non-discriminatory basis to all competitors for missile contracts." Here, the FTC was concerned that the firm could harm competition by withholding solid rocket motors from its missile-manufacturer rivals (or would increase prices for these missile components).

3 The FTC required the imposition of a firewall between Staples' B2B sales operations and Essendant in order to "restrict Staples' access to the commercially sensitive information of Essendant's customers." The FTC was concerned that Staples could use this information to "offer higher prices than it otherwise would when bidding against a reseller for an end customer's business."

to foreclose or disadvantage firms that pose a significant competitive threat to Grail and to limit the competitiveness of any MCED product" and thus "Illumina will control the fate of every potential rival to Grail for the foreseeable future." Specifically, the FTC also alleges that

> [a]s the dominant provider of NGS platforms for MCED test developers, Illumina can use its control of a critical input to foreclose or disadvantage Grail's rivals through at least the following means: by raising the test developer's prices for NGS instruments and consumables, impeding the rival's research and development efforts by denying important technical assistance and other proprietary information needed to obtain FDA approval or design a commercially successful MCED test, or refusing or delaying the execution of an agreement required to sell distributed IVD versions of the test (or offering the agreement on terms that would restrict the competitiveness of the rival's IVD test) – terms that allow rivals to compete effectively with Grail.

It is notable that the challenged transaction involves companies in the healthcare industry, which is perhaps particularly ripe for increased regulatory scrutiny given the FTC acting chair's dissents from prior Commission actions allowing transactions in this industry. Moreover, vertical mergers in industries in which there is a great deal of technological innovation may be more likely to attract regulatory attention.

In response to the FTC's litigation, Illumina announced that it is "irrevocably offering" a "standard contract to any U.S. oncology customer" which it says includes, among other things, terms for "guaranteed access to the latest sequencing products" for 12 years, "no price increases for the sequencing products covered by the agreement" and "guarantees lower pricing for the sequencing products by 2025."

Significance

The Commission's vote to challenge the Illumina-Grail transaction was unanimous, and the two Republicans' votes suggest that the challenge follows existing policy regarding vertical merger enforcement rather than breaking new ground.[4] Indeed, a raising rivals' costs/foreclosure theory of competitive harm is a centerpiece of the agencies' current Vertical Merger Guidelines. Nevertheless, the Commission's action serves as an important reminder that investors planning exit strategies (or contemplating potential exit strategies at the time of investment) must take into account antitrust considerations not only for proposed horizontal transactions involving a portfolio company's competitors, but also for vertical acquisitions. It is also worth bearing in mind that an increased focus on vertical deals in the United States may have consequences for regulators in other jurisdictions: Those non-US agencies that are already skeptical of

[4] Commissioner Christine Wilson tweeted: "Will the FTC be harsher on vertical mergers once a full complement of Democratic commissioners arrives? Almost certainly. Is Illumina/Grail a data point in that trend? No -- see Cytyc/Digene." She was referring to the FTC's move to block Cytyc Corp.'s acquisition of Digene Corp. in 2002, a challenge in which the FTC raised vertical concerns. The parties ultimately abandoned the deal.

vertical deals may become even more skeptical if the regulatory climate in the United States becomes more aggressive.

In addition, the Illumina-Grail situation is of interest because of the parties' attempt to address competitive concerns by offering a contractual fix (here, a long-term supply agreement with pricing commitments) after the government instituted its challenge. A similar move was made in the recent past. In the AT&T-Time Warner case, the parties faced a challenge based in part on the theory that the combined firm could raise programming prices to AT&T's rival distributors. To attempt to counter this, a week after the government sued to block the deal, Time Warner's Turner Broadcasting unit "irrevocably" offered to arbitrate programming carriage disputes.

The government did not look favorably on this move, arguing that the offer was not in fact "irrevocable" for reasons having to do with state law, and, moreover, allowing "a defendant to avoid liability by promising to modify its behavior temporarily would 'allow a party to thwart judicial review through its own machinations' and 'create incentives for firms to take similar actions in the future to evade antitrust review.'" The government also argued that the offer was an "attempt at a remedy" and "cannot overcome the sufficiency of the government's evidence on liability." The district court, however, viewed the offer as "extra icing on a cake already frosted" in its analysis of the deal. The court of appeals relied more heavily on the offer in upholding the district court's ruling in favor of the merger.

It remains to be seen how the court will view Illumina's gambit, but it bears watching as it – taken together with the court of appeals' opinion in the AT&T-Time Warner case – may inform the extent to which merging parties will be able to proactively undertake unilateral commitments as a viable and reliable strategy to address perceived risks associated with vertical integration.

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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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