MORRISON | FOERSTER

Legal Updates & News

Legal Updates

European Commission Adopts New Guidelines for Non-Horizontal Mergers

December 2007

by Peter J. Edlind, Jonathan Gowdy

Related Practices:

- Antitrust & Competition Law
- Corporate

On November 28, 2007, the European Commission adopted guidelines ("Guidelines") that describe the general analytical framework used by the Commission to evaluate the competitive impact of "non-horizontal" mergers under the EC Merger Regulation. (Non-horizontal mergers include "vertical" mergers of firms at different levels of the supply chain and "conglomerate" mergers of companies active in closely related, but not directly competing, markets). The Guidelines describe the principal market conditions and scenarios under which the Commission believes competitive harm can result from these transactions, as well as the conditions that indicate such harm is unlikely to occur.

While most businesses are likely to welcome the Guidelines for providing greater transparency and insight into the Commission's merger review standards, the principal theories of harm underlying the Guidelines remain controversial among antitrust economists, scholars, and courts. Indeed, the Guidelines have been adopted against a back-drop of criticism leveled at the Commission by the European Court of First Instance for the analysis of non-horizontal mergers in the *Tetra Laval/Sidel* and *GE/Honeywell* judgments.

In addition, while U.S. and European merger enforcement has converged in many ways in recent years, the U.S. agencies have not fully embraced some of the "foreclosure" theories of competitive harm endorsed in the Guidelines. These policy differences among enforcement agencies have occasionally resulted in different conclusions regarding the lawfulness of transactions (e.g., *GE/Honeywell)*. Thus, despite the welcome transparency offered by the Guidelines, future enforcement efforts against non-horizontal mergers are likely to continue to generate significant debate and criticism given the lack of consensus in this area of law.

Summary of Guidelines

The Guidelines sets forth the Commission's general analytical framework for evaluating non-horizontal mergers, including the efficiency benefits and potential harms from non-horizontal mergers. We briefly summarize the key provisions below:

1. Pro-Competitive Efficiencies. The Guidelines expressly acknowledge that (a) non-horizontal merger are less likely to result in harm than "horizontal" mergers between competing firms and (b) these transactions often generate pro-competitive efficiencies, such as the elimination of double mark-ups and lower transaction costs.

2. Safe Harbour Provision. Non-horizontal mergers with a post-merger market share not exceeding 30% in the relevant markets and an HHI below 2000 are unlikely to pose a competition concern. However, when one or more of the following "special" circumstances is present, the Commission may still decide to investigate further:

- The merger involves a company that is likely to expand significantly in the near future, for instance, due to a recent innovation

- The existence of significant cross-shareholdings or cross-directorships
- A high likelihood of one of the merging firms disrupting coordinated conduct
- Indications of past or current coordination

3. Non-Coordinated Effects. The Guidelines focus heavily on the market scenarios in which the Commission believes anticompetitive "foreclosure" of competitors may occur. These "non-coordinated" or "unilateral" effects primarily arise when the merged entity has the ability and incentive to foreclose competitors' access to supplies (input foreclosure) or markets (customer foreclosure). According to the Guidelines, the foreclosure does not need to force competitors out of a market to be problematic; if competitors are able to compete less effectively and the merged entity (and possibly other third party competitors) can profitably increase prices, the foreclosure is sufficiently anticompetitive.

- **Input Foreclosure.** This type of foreclosure can occur when the merged entity increases the costs of (or restricts access to) a necessary input product utilized by competitors in the downstream market. As a result of this strategy, competitors may be disadvantaged, and the merged entity could potentially increase its prices charged to customers. The Commission will take into account any procompetitive efficiencies generated by the merger that are substantiated and allow the merged entity to reduce prices to customers. The presence of vertically integrated competitors may also prove to act as a competitive constraint on the merged entity.

- **Customer Foreclosure.** Customer foreclosure can occur if the merged entity ceases to purchase from upstream competitors, sources only from its own upstream division, or only purchases on conditions less favourable than it would have done absent the merger. This, in turn, may impair the ability of upstream firms to compete efficiently or effectively and thereby raise the costs of competitors active in the downstream market. For instance, the Guidelines indicate that when the merger involves an important customer that has significant market power in the downstream market, there is a greater likelihood of customer foreclosure. However, the existence of several upstream suppliers post-merger that are not affected by the foreclosure may act as a competitive constraint on the merged entity.

  The Guidelines also require that the merged entity have a profitable incentive to foreclose. For instance, by not purchasing from upstream competitors, internal costs may increase. Unless the gains from higher expected prices in the downstream market are likely to exceed these increased input costs, the merged firm may not have any incentive to engage in this foreclosure strategy.

- **Monopoly Leveraging.** The Guidelines recognize that conglomerate mergers usually do not lead to competition concerns; however, the Commission will examine whether the merged entity has the ability and incentive to leverage a strong market position from one market to another by engaging in tying, bundling or other exclusionary conduct. If these practices are likely to occur and lessen competitors' ability or incentive to compete with the merged entity, competitive pressure on the merged entity may be reduced, thereby allowing it to charge higher prices for its products. Any such detrimental effect would be evaluated by the Commission in the light of efficiency arguments forwarded by the parties.

- **Access to Competitively Sensitive Information.** The Guidelines also mention that non-horizontal mergers may give the merged entity the ability to price less aggressively to the detriment of consumers if the merger provided the company with access to sensitive information regarding the activities of its upstream or downstream rivals.

4. Coordinated Effects. The Guidelines also provide general scenarios in which "coordinated effects" may occur due to a non-horizontal merger, but do not significantly elaborate on the application of the tests set forth by the European Court of First Instance in the *Airtours* judgment. These effects can potentially arise if the merger enables competitors to more easily or effectively (i) coordinate and raise prices, (ii) monitor the terms of coordination, or (iii) punish rivals when they deviate from the terms of coordination. Likewise, if the merger could reduce the ability of other competitors to cheat or deviate from the terms of coordination, for instance, by eliminating a disruptive buyer in the market, then the transaction could increase the risk of anticompetitive coordinated effects.