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Expert Analysis

AT&T-Time Warner and a Rare Judicial Perspective on Vertical Mergers

By
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A federal trial judge rejected the Department of Justice's challenge to AT&T Inc.'s proposed acquisition of Time Warner Inc., denying the government's request to block the proposed merger of a leading communications provider with a major entertainment company. Aside from the intense public interest in this transaction, the opinion provides a rare judicial perspective on vertical mergers: adjudicated decisions on vertical mergers are infrequent and it has been about forty years since the last time the Antitrust Division of the Department of Justice (DOJ) went to court seeking to enjoin a vertical merger. About a week before the court handed down the *AT&T* decision, the Federal Trade Commission (FTC) announced the settlement of an enforcement action in another vertical merger in a distinctly unrelated business—solid rocket motors used in integrated missile systems. In that matter, Northrop Grumman Corp. agreed to continue to supply solid rocket motors to rivals on a nondiscriminatory basis to resolve the FTC's concerns about its acquisition of Orbital ATK, Inc.

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In antitrust parlance, companies are horizontally situated if they compete with one another at the same level of distribution, as was the case in AT&T's proposed acquisition of rival cellular service provider T-Mobile, which was challenged and subsequently abandoned in 2011. On the other hand, a vertical merger involves companies that buy and sell to one another, in the way that Time Warner contracts with AT&T's DirecTV to distribute HBO, CNN, TNT and other networks. Generally speaking, vertical mergers are less likely to raise antitrust concerns than horizontal mergers, where competition between head-to-head competitors may be eliminated.

In contrast, vertical mergers often provide cognizable economic efficiencies due to the elimination of the markup a seller charges its customer. At the same time, some vertical mergers may harm competition by enabling the merged firm to deny key inputs to rivals or raise their costs.

AT&T-Time Warner

In October 2016, AT&T announced its agreement to acquire Time Warner for around $108 billion (including debt). In addition to its landline and cellular telephone services, AT&T also owns satellite video distributor DirecTV. Time Warner includes CNN, TNT, TBS and other networks (the Turner Networks), HBO and the Warner Bros. studios. The DOJ investigated and in November 2017 filed a suit to block the proposed merger. Judge Richard J. Leon of the U.S. District Court for the District of Columbia issued his decision on June 12 in United States v. AT&T Inc., No. 17-2511 (D.D.C).

The Department of Justice based its lawsuit on three theories of harm

to competition. First and foremost, the DOJ posited that AT&T would be able to raise the prices charged to cable companies and other multichannel video distributors for carrying Time Warner networks. Under this increased leverage theory, AT&T would be emboldened to negotiate for higher rates from other video distributors, such as Spectrum or Cox, because in the event of an impasse leading to a "blackout" of Turner Networks, some of the other distributor's subscribers would switch to AT&T's DirecTV, which is available nationwide, to view their favorite shows and sporting events. The DOJ's second theory of harm asserted that AT&T would hinder the development of virtual video distributors—companies like Sling or YouTube TV that provide access to live video programming on computers and devices—by restricting their access to "must have" Time Warner content. Finally, the DOJ alleged that AT&T would have the incentive and ability to prevent rival distributors from using HBO as a promotional tool to attract and retain customers.

Following a six-week bench trial, the court handed down a 172-page opinion finding that the government failed to meet its burden to establish that the proposed combination is likely to lessen competition substantially. But, before turning to discuss the key issues in the court's opinion, we address several procedural points. About two days after the decision was handed down, AT&T and the DOJ reached an arrangement that allowed the merger to close right away (instead of waiting for six days to give DOJ a chance to appeal, as had been previously arranged) but required AT&T to "hold separate" Time Warner's Turner Networks until February 2019. This deal allowed AT&T to close the acquisition and, among other things, avoid paying Time Warner a $500 million reverse break-up fee. If the DOJ would have promptly persuaded the court of appeals to order the parties not to close during the pendency of an appeal, the acquisition could not have closed by the June 22 drop dead date, triggering the break-up fee. At the same time, by securing a hold separate agreement, the DOJ preserved the possibility of a successful divestiture of Turner Networks or a part of that business if the appellate court and subsequent proceedings require such relief. At press time, the DOJ has not yet announced whether it intends to appeal the decision.

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The court determined that the DOJ failed to meet its burden of proof, but the decision was informed by the court's acceptance of AT&T and Time Warner's asserted rationale for the merger—to address competition from fast-growing, data-rich rivals, such as Netflix, which have a significant advantage in targeted advertising because of the direct, digital relationship between the content provider and the viewer—and the DOJ's acknowledgment that the merger would lead to hundreds of millions of dollars in cost savings for DirecTV customers.

The court rejected the increased leverage theory of harm, determining that AT&T was unlikely to withhold Time Warner content from rivals for significant periods. The court emphasized that the DOJ was not asserting a foreclosure theory, but rather an increased leverage case, which depends on a negotiating advantage arising from a threat to withhold content. The court then noted that Time Warner benefits from wide distribution of its content through increased advertising and fee revenue and suffers losses from long-term blackouts.

Next, the court found the terms "must have" or "must carry" to be hyperbole and pointed to examples of distributors that survived without Turner networks or live sporting events and consumers' ability to "wire around" live sports blackouts. It noted that Turner never resorted to a long-term blackout and had only two one-month blackouts in recent memory. The court observed that prior vertical media mergers—most notably Comcast's acquisition of NBC Universal in 2011—did not

lead to higher prices. The court also discounted AT&T's prior statements about those mergers. Finally, the court determined that AT&T was not likely to restrict or withhold "must have" content from rival virtual video distributors because AT&T generates revenue when its cellular subscribers use data to watch video on their smartphones even if they use a rival's service.

The decision did not set forth novel pronouncements on legal principles and seems to have been drafted carefully to avoid ruling on legal issues and rely instead on factual determinations, which are harder to overturn on appeal.

Vertical Remedies

In most merger antitrust cases brought under §7 of the Clayton Act, the court is asked to determine if a proposed acquisition may substantially lessen competition or tend to create a monopoly. This requires a prospective, predictive analysis of what might happen in a given market if a merger were permitted to proceed. That task is arguably even more difficult in a vertical merger where the number and concentration of horizontal competitors remains the same yet one competitor's cost structure and incentives may change.

When the government and merging parties cannot reach a settlement to resolve antitrust concerns, both sides face the risk that a court will not agree with their assessment of the market and rule against them. Since predicting the impact of vertical mergers may be particularly complicated, parties frequently favor settlements. Indeed, several commentators initially indicated that AT&T's acquisition of Time Warner was likely to be resolved like Comcast's acquisition of NBC, with remedies designed to prevent unbending negotiating tactics and blackouts, among other things. Yet, in this case, the DOJ would not settle for behavioral remedies that would have imposed restrictions on negotiations and other conduct but otherwise allow the merger to close without divestitures. The Assistant Attorney General for antitrust, Makan Delrahim, has criticized behavioral remedies for imposing regulatory schemes that distort market incentives and are administratively difficult to enforce. Instead, he expressed a clear preference for structural remedies—that is, divestitures—that provide clear incentives and require minimal oversight by antitrust enforcers.

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Northrop-Orbital ATK

In contrast, the FTC recently agreed to rely on behavioral remedies to resolve antitrust concerns in a vertical merger in *In re Northrop Grumman Corporation and Orbital ATK,* FTC File No. 181-0005 (June 5). Although the FTC stated that it continues to prefer structural remedies, this enforcement action demonstrates that, in appropriate circumstances, the FTC does agree to behavioral remedies. The FTC alleged that, absent the remedies contained in the settlement, Northrop's acquisition of Orbital ATK would likely reduce competition in violation of the Clayton Act: Northrop would have had the ability to disadvantage rival missile system suppliers bidding for defense contracts by denying or limiting their access to Orbital ATK's solid rocket motors, one of only two options for this essential component. In addition, Northrop could have obtained its rivals' sensitive proprietary information. To remedy these concerns, Northrop agreed to establish firewalls and to make its solid rocket motors available to third parties on a non-discriminatory basis for twenty years. Northrop's compliance with the consent order will be overseen by a compliance officer appointed by the Department of Defense.

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