DOJ'S CHALLENGE TO VERTICAL AT&T/TIME WARNER MERGER EXPERIENCES FAILURE TO LAUNCH

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The District Court for the District of Columbia rejected the request by the U.S. Justice Department's Antitrust Division ("DOJ") to enjoin the merger of AT&T's television distribution business with Time Warner's video content business. The court found that DOJ failed to prove DOJ's theory that the vertical merger (which would admittedly generate efficiencies that would reduce prices for AT&T's existing customers) would substantially reduce competition by increasing the merged entity's bargaining leverage in licensing video content. The court found that DOJ's case did not adequately account for the realities of the marketplace, including (i) the intense and increasing competition in the television and video distribution business, (ii) the incentives that are inherent in how the industry earns its revenues, and (iii) the actual business practices in the industry.

The case demonstrates the importance in antitrust litigation of showing that the legal and economic theories underlying an antitrust charge are truly consistent with the facts in the marketplace. It also demonstrates the vulnerability of econometric modeling to demonstrations that the models omit key variables or rely on inaccurate data.

BACKGROUND

DOJ challenged AT&T's proposed merger with Time Warner on the ground that the transaction would violate Section 7 of the Clayton Act, which prohibits mergers and acquisitions that may substantially lessen competition. AT&T distributes television programming through (i) its DirecTV subsidiary (a national satellite-based service), (ii) U-verse (a regional landline telephone-based service), and (iii) DirecTV Now (an online video service). Time Warner licenses television content to distributors (including AT&T) through (i) its Turner Broadcasting System networks (including TNT, TBS, and CNN), (ii) Warner Brothers Entertainment studios, and (iii) the HBO and Cinemax premium networks.

In its complaint, DOJ primarily alleged that Time Warner controlled "must-have" programming (particularly Turner live sports programming and certain HBO programming) without which distributors like cable television and satellite television companies would have a hard time attracting subscribers. DOJ argued that, by giving AT&T control over such "must-have content," the merger would enhance the merged company's bargaining leverage in its negotiations with competing distributors for the licensing of the Time Warner content. Key to the government's theory was AT&T's ownership of DirecTV, which competes with a variety of cable and telephone-based distribution services. In pre-merger negotiations with cable companies and other distributors, Time Warner's bargaining position was restrained by the loss of revenues that would accompany its failure to come to terms with a distributor. DOJ argued that the merged AT&T/Time Warner could offset a portion of those lost revenues by switching the subscribers of the blacked-out cable distributor to DirecTV. This ability to switch some consumers to DirecTV, DOJ alleged, increased the merged company's bargaining leverage and would result in distributors that compete with DirecTV paying higher fees for Time Warner content and, subsequently, in consumers paying higher subscription fees.

Defendants argued that the evidence at trial failed to show that there was a significant likelihood that prices would substantially increase after the merger or even that an increase was probable. While Time Warner's programming is popular, Defendants argued, it is not truly indispensable to distributors. Further, Defendants argued that DOJ's econometric merger simulation models (which embodied DOJ's increased bargaining leverage theory), when corrected for alleged errors in DOJ's calculations, showed that prices would actually decrease, not increase.

A similar merger of a video programming distributor with a video content provider had previously occurred when Comcast merged with NBC/Universal. In that case, the merging parties had agreed with DOJ on a consent decree that required, for a period of years, that the merged entity arbitrate with rival distributors regarding rates for the content controlled by the merged firm and that the merged entity not blackout the rival distributor from such content while the arbitration proceeded. In AT&T/Time Warner, however, DOJ declined to enter into such a behavioral remedy and insisted on structural relief such as blocking the *AT&T/Time Warner* merger or requiring the merged entity to divest key programming resources. The Defendants in AT&T argued that AT&T has unilaterally given distributors a binding commitment (the "AT&T Commitment") that is similar to the *Comcast/NBC Universal* [1] consent decree providing for arbitration of rates for Turner programming and prohibiting a cutoff of content to the distributor during arbitration.

THE LEGAL STANDARD FOR JUDGING MERGERS

Section 7 of the Clayton Act prohibits mergers where "the effect of such acquisition *may* be *substantially* to lessen competition" (emphasis added). The trial court interpreted this standard to mean that DOJ has the burden of demonstrating that the merger is "likely to lessen competition substantially." While the court did not specify how probable the competitive harm must be, a mere possibility of harm will not suffice. Citing prior precedents, the court said the substantial lessening of competition must be "sufficiently probable and imminent to warrant relief."

Inherent in the court's obligation, the court explained, is an obligation to examine the probable future competitive conditions in the market, giving due consideration to current developments in the market. In this case, the court interpreted that standard to include giving due consideration to the effect of the intense and increasing competition between cable and satellite distributors of video programming and firms (known as Virtual MVPDs) that are distributing over the Internet smaller bundles of content at a lower cost. Antitrust theory and speculation, the court said, cannot substitute for real-world facts in the marketplace.

PROVING AN ANTICOMPETITIVE EFFECT FROM A VERTICAL MERGER

In this case, the merger is a vertical one between a supplier in an upstream market and one of its customers in a downstream market. Unlike in a horizontal merger between two firms in the same market, the vertical merger does not create an increase in the merged firm's market share. Accordingly, the court noted, there is "no short-cut way to establish anticompetitive effects, as there is in horizontal mergers," where a certain level of post-merger concentration gives rise to an inference of anticompetitive effect.

Historically in the United States, allegations of an anticompetitive effect from a vertical merger commonly have relied upon showing that the merged firm will control the supply of an input for production or control an outlet from the market so that the merged firm can raise its rivals' costs or exclude them from the market. Similarly, the European Commission generally relies upon a showing of the merging firms having (i) market power in either the upstream or downstream market, (ii) an incentive to engage in a foreclosure strategy, and as a result (iii) a significant adverse effect on competition. According to the European Commission, vertical mergers are unlikely to have a significant effect on competition unless the merged firm will have a share of at least 30% or more in either the upstream or the downstream market and the concentration in that market exceeds levels specified in the European Commission's guidelines.

In this case, however, DOJ made no allegation that the merged firm would control a dominant share of either the video content market or the video distribution market. Instead, DOJ's allegation of enhanced bargaining leverage depended upon the theory that Time Warner owned "must-have" video content from its Turner and HBO networks, and the merger of that content with AT&T's distribution would enhance the merged firm's leverage to extract higher fees from rival distributors. According to DOJ, in the event of a failure to reach agreement with any competing distributor, the merged firm would have a better alternative than the pre-merger Time Warner because the merged firm could reduce its lost revenues by shifting some of the rival programmer's customers to the merged firm's own DirecTV program distribution service. That change in Time Warner's options in the event of an impasse would, according to DOJ, cause distributors to pay more for Time Warner's content.

FAILURE TO PROVE ENHANCED BARGAINING LEVERAGE

The trial court rejected DOJ's "enhanced bargaining leverage" theory as inconsistent with the real-world facts in the marketplace. Although the court acknowledged that holding a vertical merger unlawful would generally require a balancing of the pro-competitive, efficiency-enhancing effects of the merger against its anti-competitive effect, the court here found no such balancing necessary because it found that no anti-competitive effects had been proven.

First, the court did not believe the merger was aimed at enhancing bargaining leverage with rival distributors. The court found credible the Defendants' evidence that the transaction was designed to increase the distribution of Time Warner content on wireless devices and to marry AT&T's data on household preferences with Time Warner's stock of content and advertising slots to permit the merged entity to deliver the more valuable targeted advertising that neither firm alone can offer.

The court also concluded that DOJ had not proven that the alleged enhancement of bargaining leverage would occur. The court found it highly persuasive that there were actually few examples in which significant content providers and program distributors reached an impasse and the content provider actually blacked out its content from the distributors. Further, Turner's content, while attractive, was held to not actually be indispensable for program distributors. In addition, because video content providers (including Time Warner) are dependent upon the very substantial licensing fees and advertising revenues that they derive from licensing content to distributors, the court regarded it as implausible that either the distributors' or the merged firm's bargaining position would be influenced by the comparatively small amount of incremental revenues that would in fact be available to the merged firm by switching a rival distributor's customers to DirecTV.

Although DOJ supported its case with testimony from rival distributors, who described Turner's content as "must-have," the court found their testimony unpersuasive for several reasons. First, as competitors of AT&T, they may be seeking to avoid having to compete with a more efficient post-merger AT&T, with lower costs and prices. In addition, the court considered their testimony speculative since none had actually done calculations of what they and Time Warner would lose in the event a bargaining impasse led to a cutoff of content and whether it is reasonable to expect such a cutoff. The court found more persuasive the AT&T and Time Warner witnesses who testified to the losses that a cutoff would generate for the merged firm.

The court also was not persuaded by the AT&T and Time Warner documents that DOJ introduced to support its case, including prior AT&T regulatory filings opposing earlier mergers of content providers and video distributors, as well as company personnel's preliminary comments on this merger. The court discounted the regulatory filings as being typical competitor complaints seeking to avoid more efficient competitors and as more theoretical than specific to the current circumstances. The more recent documents the court characterized as relatively uninformed comments by low-level employees, not actual strategic commentary by those driving the deal.

On the other hand, the court found persuasive the Defendants' economic testimony that in prior real-world instances of content providers merging with program distributors ("real-world experiments"), prices to the distributors and consumers did not increase.

Nor did the court accept DOJ's expert economic testimony to support its theory of enhanced bargaining leverage. A substantial obstacle that DOJ could not overcome was the fact that DOJ's economist conceded that the vertical merger would result in the elimination of duplicate margins, which would result in $350 million in savings to AT&T's cable and satellite television subscribers. Thus, to demonstrate an overall net negative effect of the merger on consumers, DOJ would have to prove more than $350 million in prices to offset these price declines.

Furthermore, the court regarded the DOJ expert's opinion as being at odds with important facts in the market. The court considered the negotiating credibility of blackout threats to be low because negotiations on content licensing seldom result in blackouts and historically even vertically integrated content providers have not blacked out their rivals. The court also found that the data the DOJ's expert relied upon to calculate the value of the coefficients in his model (i.e., the probability of a subscriber leaving his or her existing program distributor in the event of a blackout, the probability that such a dissatisfied subscriber would switch to the merged company's DirecTV, and the AT&T profit margins on DirecTV subscribers) were erroneous, undermining the accuracy of any calculation of enhanced leverage or of price increases to distributors and their subscribers. Further, the court found that the AT&T Commitment to arbitrate content licensing rates with distributors was a significant market fact that the DOJ's expert had not accounted for in his calculations of the net effect of the merger.

The European Commission has also rejected enhanced bargaining leverage theories in connection with vertical or conglomerate mergers when no showing had been made of the merged entities' ability to foreclose competitors from the market. *BskyB/Sky Deutschland/Sky Italia* [2], for instance, involved a merger of firms primarily involved in pay television distribution in the United Kingdom and Ireland, in Germany and Austria, and in Italy, respectively. In evaluating the conglomerate and vertical aspects of the merger, the European Commission rejected the theory that by combining the negotiation of distribution rights in multiple territories, the merger would increase BskyB's negotiating leverage versus licensors of international sports and premium films, as well as television channel suppliers. The European Commission declared that the enhanced bargaining leverage theory was inconsistent with actual bargaining practices in the marketplace and that no ability to foreclose competitors had been shown.

OTHER DOJ THEORIES OF HARM

In *AT&T/Time Warner*, DOJ had two additional theories of competitive harm, which the court rejected after brief examination. First, DOJ alleged that the merged company, either unilaterally or in tacit or explicit coordination with Comcast/NBC Universal, would use its control over content to limit competition by the emerging competitors who distribute content via the Internet (including Sling TV, PlayStation Vue, Hulu Live, and YouTube TV). The court rejected this theory because of the extent of the profits that the merged company would generate by licensing its content to these additional distributors, as well as the profits to be derived from the additional use of AT&T's wireless assets that those additional distributors would generate.

The court also rejected DOJ's theory that the merged entity would prevent rival video distributors from using HBO to promote the sale of subscriptions to their distribution services. The alleged purpose would be to encourage customers to switch to DirecTV. The court found such a theory unrealistic because of the importance of such promotions to the value of HBO to Time Warner. Nor did the court accept that promotions of HBO, rather than other premium content, are sufficiently important to rival distributors for such a scheme to affect such distributors' competition with DirecTV.

STATUS

The merger of AT&T and Time Warner has been closed. DOJ did not request a stay of the trial court's decision pending appeal in the face of the trial court's *sua sponte* statement it would not grant a stay in view of the delay the parties had already experienced, the impending termination date for the contract, and the contract covenant for AT&T to pay a $500 million breakup fee if the merger were not completed before the contract's termination date. However, DOJ retains a right to file an appeal and, if successful, seek post-closing divestiture.

CONCLUSION

This opinion does not preclude challenges to vertical mergers that foreclose competition in either the upstream or downstream market. Nor does it necessarily forestall reliance on DOJ's enhanced bargaining leverage theory, since the judge's decision is based on findings that the facts simply did not support DOJ's theory. The case does, however, explicitly recognize that vertical mergers often generate pro-competitive efficiencies. Also, it demonstrates the need for each party to provide the court with a comprehensive analysis of the "real-world" facts in the marketplace that support its theory of the case, including the identity of all the parties, margin flows, profit trends, new developments, and the motivations that truly drive competitors in the market. Economic or business theories unsupported by such marketplace facts will be vulnerable.

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[1] U.S. v. Comcast Corp., 808 F. Supp. 2d 145 (D.D.C 2011).

[2] BskyB/Sky Deutschland/Sky Italia, Case No. COMP/M. 7332 (Nov. 9, 2014)

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