BRACEWELL

INSIGHTS

D.C. Circuit Upholds Vertical Merger of AT&T and Time Warner

March 6, 2019

By: ***Daniel E. Hemli*** *and* ***Jacqueline R. Java***

On February 26, 2019, the U.S. Court of Appeals for the D.C. Circuit unanimously ***affirmed*** a district court decision rejecting the U.S. Department of Justice's challenge to AT&T's $85 billion merger with Time Warner, cementing one of the biggest merger defeats for DOJ's Antitrust Division in recent history. This case was DOJ's first court challenge to a purely vertical merger since the 1970s and the most high-profile merger challenge since President Trump took office.

DOJ had sued to block the merger in November 2017, arguing that the vertical combination of content creator Time Warner and content distributor AT&T (which owns satellite pay-TV provider DirecTV) would harm competition by enabling AT&T to use its ownership of Time Warner's "must-have" popular content to increase its bargaining leverage and extract higher fees from traditional video programming distributors such as cable and satellite TV companies. DOJ argued that those higher fees would then be passed on to consumers. Following a bench trial, U.S. District Court Judge Richard Leon ruled in June 2018 in a lengthy ***opinion*** that DOJ fell far short of showing that the vertical combination would harm competition. DOJ appealed the decision.

In order to prevail on appeal, DOJ had to show that Judge Leon's factual findings were "clearly erroneous" and not plausible given the entirety of the evidentiary record. Writing for a three-judge panel, Circuit Judge Judith Rogers explained that, while the district court made some "problematic statements," DOJ's objections on appeal were unpersuasive in light of the evidence presented at trial by defendants, including real-world data and proof of a dynamic and evolving industry.

On appeal, DOJ claimed that Judge Leon misapplied economic principles, specifically the Nash bargaining theory and the principle of corporate-wide profit maximization. DOJ's expert witness, Professor Carl Shapiro, argued that because the cost of a long-term blackout would decrease for the merged entity, as some customers of a rival distributor subject to a blackout would switch to AT&T, the Nash theory predicted that Turner Broadcasting, which is part of Time Warner, would have greater bargaining leverage in negotiations with distributors. The D.C. Circuit found that Judge Leon "accepted the Nash bargaining theory as an economic principle generally but rejected its specific prediction in light of the evidence that the district

court credited." That evidence included an econometric analysis of three prior vertical mergers in the same industry, performed by the defendants' expert economist, Professor Dennis Carlton, which found that those previous transactions had not resulted in a statistically significant increase in content costs.

The D.C. Circuit also specifically noted Turner Broadcasting's unilateral commitment to around 1,000 of its distributors to arbitrate fee disputes and not black out content during a pending arbitration. These arbitration agreements with a no-blackout guarantee would be in effect for seven years. According to Circuit Judge Rogers, this undercut the government's case, because DOJ had conceded at trial that it did not consider the effects of the arbitration agreements in its econometric analysis: "[c]onsequently, the government's challenges to the district court's treatment of its economic theories becomes largely irrelevant, at least during the seven-year period."

DOJ also contended that the trial judge erred by failing to take into account the principle of corporate-wide profit maximization, whereby a business with multiple units will seek to maximize its total profits. Again pointing to real-world evidence, the D.C. Circuit noted trial testimony from executives at competitor Comcast-NBC Universal that the change in content owner NBCU's parent company did not affect its negotiations with distributors; thus, the district court could reasonably find that it was still in the best interests of the merged entity as a profit maximizer to license content broadly to other distributors instead of withholding content in an attempt to benefit one division of the merged company.

Additionally, DOJ claimed that the district court used inconsistent logic when evaluating testimony from industry witnesses, because Judge Leon gave little weight to concerns expressed by third-party distributors while crediting testimony from Time Warner executives, even though self-interest could have existed with both sets of witnesses. However, the D.C. Circuit observed that the potential for self-interest was not the only reason Judge Leon found third-party distributor testimony of little probative value; rather, Judge Leon found the distributor testimony consisted of speculative, future predictions that lacked adequate factual support, in contrast to defendant executives' testimony, which recounted specific experiences from actual prior negotiations.

Finally, DOJ argued that the district court erroneously rejected the government's quantitative model of harm, which predicted higher prices for consumers. The D.C. Circuit again commented that Professor Shapiro's model failed to consider the offer of arbitration agreements, and that it failed to account for the real-world effects of Turner Broadcasting's existing long-term contracts, which would limit Turner Broadcasting's ability to raise content prices for distributors until 2021. Moreover, it was not clearly erroneous for Judge Leon to conclude that it would be difficult to predict price increases once those contracts expire, particularly given the evolving and increasingly competitive nature of the industry, as demonstrated by the emergence of new online video on demand services such as Netflix and Hulu.

With regard to vertical merger analysis generally, although the D.C. Circuit noted the "dearth of modern judicial precedent on vertical mergers and a multiplicity of contemporary viewpoints about how they might optimally be adjudicated and enforced," the three-judge panel explicitly declined to provide further clarity regarding the proper legal standard for evaluating vertical mergers.

Shortly after the D.C. Circuit ruled in favor of the merging parties, DOJ announced that it would not appeal further.

While this case is a significant defeat for DOJ, this does not mean that transacting parties have a clear green light to pursue vertical tie-ups. Instead, parties contemplating a vertical merger or acquisition should consider several important takeaways from this case:

- **The facts matter.** As with the trial court decision, the D.C. Circuit focused on the specific facts of the case, noting multiple times the government's failure to take into account real-world evidence. Though the D.C. Circuit did not make any sweeping proclamations regarding how to analyze vertical mergers moving forward, it is clear that empirical evidence based on actual observed events will be given greater weight than predictions based solely on economic theories. So-called "natural experiments," involving a retrospective analysis of similar prior transactions, can, when available, provide powerful evidence either in support of, or in opposition to, a proposed transaction. The nature of the industry also matters – proving future anticompetitive harm is likely to be more difficult in transactions involving dynamic, rapidly evolving industries.

- **Conduct remedies can still resolve vertical merger concerns**. Both the district court and the D.C. Circuit in AT&T/Time Warner placed significant weight on the parties' irrevocable offer to arbitrate price disputes with distributors. Such "conduct" or "behavioral" remedies have often been used in the past to resolve antitrust concerns in vertical deals, but were rejected by DOJ in this case, with Assistant Attorney General Makan Delrahim, who heads DOJ's Antitrust Division, expressing a strong preference for structural remedies, such as asset divestitures. It remains to be seen whether the D.C. Circuit's apparent endorsement of a conduct remedy in a vertical merger will cause DOJ to soften its stance on this issue. Further, the FTC continues to utilize conduct relief in vertical cases; it recently ***agreed*** to behavioral fixes to remedy concerns identified with Staples, Inc.'s acquisition of Essendant, Inc.

- **Remedies can be a powerful litigation tool.** The courts' acceptance of AT&T/Time Warner's arbitration offer also indicates that remedies offered unilaterally by merging parties will be factored into a court's analysis during litigation, even if those remedies have already been rejected by antitrust regulators.

- **Anticompetitive effects of vertical mergers are not limited to price increases**. The D.C. Circuit made clear that the government does not have to show a likely price increase to prevail on a vertical merger challenge, noting that "[v]ertical mergers can create harms

beyond higher prices for consumers, including decreased product quality and reduced innovation." The panel also acknowledged that the government's guidelines for non-horizontal mergers have not been updated since 1984, providing further support for those who have called for revised vertical merger guidelines.