ICLE International Center for Law & Economics

Comments of ICLE on the Draft Vertical Merger Guidelines (Matter Number P810034)
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Although it is doubtless correct that the 1984 Nonhorizontal Merger Guidelines require updates in light of the last three decades of legal and economic developments, it is by no means clear that errors in judicial decisions or enforcement practices have led to widespread problems that are ad- dressed by the proposed changes. Indeed, harms could actually arise because there is ambiguity in the proposed guidelines that may lead either to uncertainty as to how the agencies will exercise their discretion, or, more troublingly, could lead courts to take seriously speculative theories of harm.

The purpose of this comment is to draw attention to an implicit underpinning of the draft guidelines that we believe the agencies should clearly disavow (or at least explain more clearly the complexity surrounding): the extent and implications of the presumed functional equivalence of vertical integration by contract and by merger.

Despite the fact that, among law and economics scholars, it has long been an essentially settled matter that vertical integration — whether partial integration by contract or full integration by merger — is typically procompetitive (or, at the very least, competitively ambiguous, and problematic in only very limited, stylized, and theoretical circumstances), vertical conduct of all sorts has come under increased scrutiny. Much of the new opprobrium for vertical conduct has come from the likes of presidential hopefuls, journalists, political pundits, and activists. But, more concerning, a fair amount of the resurgence in opposition to vertical restraints and mergers has come from academic economic quarters. Surprisingly, this criticism of vertical conduct also misunderstands or ignores fundamental economic concepts.

One prominent line of criticism of vertical mergers, for example, equates vertical mergers with vertical contracts, and proposes to prohibit or significantly deter vertical integration by merger because it inherently leads to competitive problems that either don’t exist or can more easily be corrected in vertical contracts. But the choice between merger and contract for firms is not so simple, especially in highly dynamic industries in which effective competition often demands both process and product innovation. In particular, the management of intangible, information assets — often the crucial in- puts in dynamic, high-tech firms — may not be as readily (or at all) accomplished by contract as by internal coordination. In the face of extreme informational uncertainties and the need for the inherently uncertain exercise of entrepreneurial judgment and dynamic

capabilities (which reside in a firm's individual decisionmakers, corporate culture, and collective ability to implement novel business processes), contracts cannot always replicate the competitive advantages of integration through merger.

This narrow view of vertical integration thus ignores and threatens to undermine dynamic competition and innovation. Indeed, if we take the organization theory and business strategy literature on the organization of firms in dynamic industries seriously, the status quo might even be over-enforcing, and leading to the deterrence of innovative, procompetitive mergers. It is insufficient merely to advert to potential price effects or innovation effects on foreclosed competitors or input providers, and there truncate the analysis. A proper evaluation of the competitive effects of vertical conduct requires an assessment of industrywide increases in innovation and of quality improvements that may accompany superficial price increases or localized constraints on innovation. Without this it is impossible to conclude that such conduct is anticompetitive.

We recently contributed two pieces to a symposium on Truth on the Market that explore the position set out above. We have attached these pieces to this comment for your convenience. We also explore all of these and related points more fully in a forthcoming article that will be published this spring by the Kansas Law Review. A draft of that article has likewise been attached.

We thank the agencies for the opportunity to comment on this important set of guidelines. We certainly advocate for clarity in the agencies' enforcement practice with respect to vertical integration, but caution that the agencies carefully consider whether the status quo — as out of date as it may be — is truly inferior to updates that introduce more ambiguity.

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