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Two Important Developments from *United States v. AT&T*

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Judge Richard Leon's June 12 decision in *United States v. AT&T Inc.* contains important insights that will be influential well beyond the confines of the now-completed $80-billion-plus merger between AT&T and Time Warner.[1] This article suggests two such insights for companies and competition lawyers.

First, the AT&T trial is an example of something that is becoming more and more common—a merger happening at a "market inflection point" where companies perceive imminent threats to their business, but government antitrust enforcers do not. In ruling for AT&T, Judge Leon was particularly persuaded by AT&T's argument that the market for video distribution was being fundamentally changed by "cord cutting" or "cord shaving" and the growth of companies like Netflix, Hulu, and Amazon Prime. The Antitrust Division of the Department of Justice (DOJ), however, came to the litigation with "a dramatically different assessment of the current state of the relevant market and a fundamentally different vision of its future development."[2] Historically, the government has a mixed record in agreeing with the company that the merger is justified by these imminent threats. It is important, therefore, to note how AT&T's careful explanation of the changing market convinced the district court that the merger should proceed.

Second, Judge Leon's decision has entrenched "elimination of double marginalization" (i.e., the elimination or collapsing of profit margins that exist at two different levels in the vertical supply chain) as a procompetitive justification for vertical mergers. Though critics had recently questioned the double marginalization rationale, Judge Leon's decision—which will likely be highly influential given the infrequency of vertical merger decisions—indicates that the elimination of double marginalization theory will be the law in this area for the foreseeable future.

Market Inflection Points

According to AT&T, cord cutting and cord shaving are causing "tectonic changes" to the video distribution business.[3] As the court described it, "cord cutting" is when a consumer discontinues services from either a traditional multichannel video programming distributor (MVPD) (e.g., cable or satellite TV company) or a so-called "virtual" cable company (e.g., DISH's Sling TV or DirectTV Now), often choosing instead to rely solely on subscription video services like Netflix.[4] Meanwhile, in the court's description, "cord shaving" is when a consumer discontinues traditional cable services and instead switches to a virtual cable company.[5] The relevance of these concepts to this case lies in their effect on DOJ's primary theory of harm to competition: its so-called "increased leveraging theory."[6] Essentially, DOJ's argument was that if AT&T acquired Time Warner and its valuable programming (e.g., HBO, CNN, TBS, etc.), it could use that programming as leverage to drive up prices in the video distribution market.[7] This was because pre-merger, when Time Warner and an MVPD engaged in a negotiation over the acquisition of Time Warner's content, both sides lost big if no deal was reached.[8] The MVPD would lose subscribers who wanted to see the Time Warner content but couldn't, while Time Warner lost the subscriber fees the video distributor would pay to distribute the content. But post-merger, the merged company would no longer have that same downside risk. That's because some portion of the negotiating MVPD's subscribers (i.e., those who place a high value on Time Warner programming) would switch to DirecTV or U-verse – MVPDs that are owned by AT&T. Under DOJ's theory, the ability of the new merged company to mitigate some of its potential losses in this way would enable it to demand higher and higher prices.[9]

However, according to AT&T, the cord-cutting phenomenon changes this whole calculation. In particular, DOJ's underestimation of the prevalence of cord cutting (and to a lesser extent, cord shaving) led it to underestimate how many consumers would switch to the new merged company. As AT&T's post-trial brief explained, DOJ's increased leverage model "assumes an inflated 'diversion rate,' i.e., the percentage of departing subscribers who would sign up for an AT&T distribution service rather than one of the many other alternatives. In particular, [DOJ's expert] underestimated the rate of 'cord-cutting,' leading him to underestimate the number of subscribers who would divert to online distributors, rather than a traditional service . . . . Correcting his cord-cutting error transforms the projected price effect [from the proposed merger] into a price *decrease* [for consumers]."[10]

Judge Leon was plainly convinced by AT&T's argument that cord cutting was having a revolutionary effect on the industry: the opinion describes the "dramatic growth" of "web-based companies [that] are harnessing the power of the internet and data to provide lower-cost, better-tailored programming content directly to consumers."[11] And to underline its point, Judge Leon laid out statistics, reciting how traditional cable companies were losing millions of subscribers while "Netflix added 2 million subscribers in the last quarter alone."[12]

In fact, the judge wholeheartedly agreed with the effect that cord cutting had on DOJ's theory in this case. The court pummeled DOJ's analysis of this aspect of the merger, writing that DOJ's estimate of cord cutting was based on "discredited" data[13] and failed to grapple with AT&T's "real-world evidence regarding the prevalence of cord cutting in the industry."[14] This led the district court to conclude that the Government "failed to provide adequate support for . . . [its] model's predicted net consumer harm."[15]

AT&T is certainly not the first time that the Government has decided to intervene (or not intervene) at the inflection point of revolutionary change coming to a market. A few historical examples illustrate that the Government has come to different conclusions on the decision to intervene in past mergers:

- Blockbuster– Hollywood Video: In November 2004, the largest video rental company in America, Blockbuster Video, announced that it would try to acquire the second-largest video rental company in America, Hollywood Video, for $991 million.[16] Months later, in March 2005, Blockbuster dropped its bid after the Federal Trade Commission communicated to them that it was planning to sue to enjoin the acquisition.[17] Among the FTC's concerns was that the merged company would have too much control over video rental pricing.[18] Blockbuster had argued that the merger was key to competing in the changing marketplace, citing competition from Netflix and download platforms such as iTunes.[19] Just five years later, Blockbuster filed for bankruptcy protection, citing the competition from "rivals providing online and mail-based services."[20]
- Sirius-XM: In February 2007, the two largest satellite radio companies, Sirius and XM, announced plans to merge and create "a de facto monopoly in satellite services" with more than 17 million subscribers.[21] More than a year later, DOJ approved the merger—even in the face of opposition from consumer groups, broadcasters, and members of Congress. DOJ's non-intervention was based on its judgment that the satellite radio market had arrived at an inflection point where robust competition from myriad sources, including iPods and internet radio, would prevent prices from rising post-merger.
- Advocate Health Care-Aurora Health Care/Advocate Health Care-North Shore University Health System: Advocate Health and North Shore University Health—two Chicago-area hospital systems—announced plans to merge in September 2014.[22] But the FTC was successful in enjoining the merger, charging that it would raise prices and lower the incentives to improve the quality of care, and the hospital systems dropped their plans to merge in March 2017.[23] Yet one year later, the FTC approved a merger between Advocate Health and Aurora Health.[24] One difference between the two deals was the continuing rapid pace of change in the health care industry.

This history—and the *AT&T* decision—underline how important it is for merger advocates to aggressively describe the large-scale and revolutionary market changes that often prompt these large mergers. As in *AT&T*, they may one day be heard by a sympathetic judicial audience.

Double Marginalization

Double marginalization "refers to the situation in which two different firms in the same industry, but at different levels in the supply chain, each apply their own markups (reflecting their own margins) in pricing their products. Those 'stacked' margins are both incorporated into the final price that consumers have to pay for the end product. By vertically integrating two such firms into one, the merged company is able to 'shrink that total margin so there's one instead of two,' leading to lower prices for consumers."[25] In assessing the procompetitive effects of the AT&T-Time Warner merger, DOJ conceded that the elimination of double marginalization was one such procompetitive effect. Judge Leon agreed and discussed the concept at some length in his opinion.[26]

This favorable treatment by both the district court in a high-profile opinion likely means that elimination of double marginalization has been entrenched in the case law as a "standard benefit associated with vertical mergers."[27] And given the paucity of published judicial opinions on vertical mergers (*AT&T* was the first vertical merger case litigated by DOJ in more than 40 years), it will take some time and effort to displace.[28] Indeed, the district court was well-aware the influence its opinion would have, as it specifically commented on "lack of modern judicial precedent involving vertical merger challenges."[29]

The district court's full-throated acceptance (and DOJ's concession) has, therefore, effectively blunted the criticism that elimination of double marginalization theory has come in for recently.[30] And, thus, in spite of this criticism, the bottom line from *AT&T* is that when evaluating most vertical mergers, it will be important to account for the elimination of double marginalization as a benefit of such combinations.

This Update was also published in Law360 *as part of Jenner & Block's monthly Antitrust Law Update series.*

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[1] *See United States v. AT&T, Inc.*, No. 17-cv-2511 (RJL), 2018 WL 2930849 (D.D.C. June 12, 2018).

[2] *Id*. at *1.

[3] *Id*.

[4] *Id*. at *9.

[5] Id.

[6] *Id*. at *29-31.

[7] *Id*. at *29.

[8] *Id*. at *31.

[9] *Id*.

[10] Post-Trial Br. of Defs. AT&T Inc., DirectTV Grp. Holdings, LLC, & Time Warner Inc. at 12, *AT&T Inc.*, 2018 WL 2930849 (No. 17-cv-2511 (RJL)), ECF No. 121.

[11] *AT&T Inc.*, 2018 WL 2930849, at *8.

[12] *Id*. at *6, 9.

[13] *Id*. at *56

[14] *Id*. at *57.

[15] *Id*.

[16] Mike Musgrove, *Blockbuster Ends Effort to Acquire Competitor*, Wash. Post., Mar. 26, 2005, http://www.washingtonpost.com/wp-dyn/articles/A2310-2005Mar25.html.

[17] Rong-Gong Lin II, *Blockbuster Ends Bid for Rival Firm*, L.A. Times, Mar. 26, 2005, http://articles.latimes.com/2005/mar/26/business/fi-blockbuster26.

[18] *Id*.

[19] *Id*.

[20] *Blockbuster Files for Bankruptcy*, N.Y. Times, Sept. 23, 2010, https://dealbook.nytimes.com/2010/09/23/blockbuster-files-for-bankruptcy.

[21] Philip Shenon, *Justice Dept. Approves XM Merger with Sirius*, N.Y. Times, Mar. 25, 2008, https://www.nytimes.com/2008/03/25/business/25radio.html.

[22] Lisa Schenker, *North Shore, Advocate Drop Merger Plan After Judge's Ruling*, Chi. Trib., Mar. 7, 2017, http://www.chicagotribune.com/business/ct-advocate-northshore-merger-decision-0308-biz-20170307-story.html.

[23] *Id*.

[24] Lisa Schencker, *Advocate Health Care Finalizes Merger With Wisconsin Hospital System*, Chi. Trib., Apr. 2, 2018, http://www.chicagotribune.com/business/ct-biz-advocate-aurora-merger-done-20180403-story.html

[25] *AT&T*, 2018 WL 2930849, at *28 (citations omitted).

[26] *Id*. at *28-29.

[27] *Id*. at *28 (internal quotation marks omitted)

[28] *Id*. at *25.

[29] *Id*.

[30] *See, e.g.*, Steven C. Salop, *Invigorating Vertical Merger Enforcement*, 127 Yale L.J. 1962, 1970-71 (2018).

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