February 28, 2019

D.C. Circuit Affirms District Court's Denial of DOJ's Request for Injunction in AT&T-Time Warner Merger

On February 26, 2019, the United States Court of Appeals for the District of Columbia Circuit held that the U.S. Department of Justice (DOJ) failed to show that the district court clearly erred in denying the government's request for a permanent injunction to block the AT&T-Time Warner merger. The appeals court cited the "real-world" evidence from AT&T and Time Warner's expert – upon which the trial court relied heavily – as well as gaps in the government's expert model. The DOJ has reportedly said it has no plans to appeal the decision. This case has attracted significant attention in part because it was the first litigated vertical merger challenge in decades.

Background

In the fall of 2016, AT&T announced that it proposed to acquire Time Warner. Time Warner produces video content at its Warner Bros. studio and licenses both its own and third-party content to programming distributors through its various networks, including HBO and CNN. AT&T is a multichannel video programming distributor (MVPD) that distributes video content to subscribers through both satellite and cable systems. Thus, the transaction would create a vertically-integrated firm which could both produce and distribute video content.

DOJ's complaint. After a lengthy investigation, in November 2017, the DOJ filed suit in the United States District Court for the District of Columbia alleging that the proposed transaction would violate Section 7 of the Clayton Act.[1] Among other things, the government alleged a vertical theory of harm – specifically that the combined firm could raise the content costs of rival distributors by credibly threatening to withhold (*i.e.*, "blackout") Time Warner content. The DOJ alleged that the combined firm would know that potential lost fees from rivals for this content could be offset by profits from some of the rivals' subscribers switching to AT&T's distribution services.[2] It also alleged that this leverage could lead to higher costs for subscribers, "[b]ecause video distributors aim to cover programming cost increases by raising the prices they charge their customers."[3] Additionally, the complaint contained allegations that the merger would harm online video distribution.[4]

1 Complaint, U.S. v. AT&T, Inc. (D.D.C. Nov. 20, 2017).

2 *See id.* ¶¶ 4-6, 35-36.

3 *Id.* ¶¶ 7, 38.

4 *Id.* ¶¶ 8-9, 40.

The DOJ sought to permanently enjoin the transaction. To address the government's concern that AT&T-Time Warner would threaten blackouts to raise its rivals' costs, Turner, a division of Time Warner, sent what were described as irrevocable offers to distributors stating that it would engage in arbitration of future content disputes without the threat of blackouts.[5] These were modeled after remedies accepted by the DOJ to resolve concerns in prior vertical integrations in this industry.[6] The government pressed forward with its case nevertheless.

Trial. At trial, the government argued that, consistent with the Nash theory of bargaining, after the merger, AT&T-Time Warner would gain leverage and thus have the ability to increase prices for its content. (According to the theory, as characterized by the appeals court, in a two-party negotiation "where both parties are ultimately better off by reaching an agreement," the party facing the greater loss has decreased bargaining leverage, and the party with "more bargaining leverage . . . is more likely to achieve a favorable price in the negotiation.")[7]

To support its theory, the government introduced evidence including "statements contained within defendants' prior regulatory filings and internal business documents as well as testimony from third-party competitor witnesses" and an economic expert opinion "that a post-merger Turner would be able to extract greater affiliate fees from distributors due to increased bargaining leverage Turner would gain on account of its relationship with AT&T."[8] The defendants disputed the DOJ's evidence and its expert's conclusions, and argued that "real-world pricing data demonstrates that prior instances of vertical integration in this industry have not produced the increased-leverage effects" asserted by the DOJ.[9]

The district court decision. Noting the court's "'uncertain task' of 'making a prediction about the future,'" in June 2018, Judge Richard J. Leon denied the DOJ's request to enjoin the transaction.[10] In his 172-page opinion, Judge Leon found that the DOJ did not meet its burden to demonstrate "that the proposed merger is likely to increase Turner's bargaining leverage in affiliate negotiations."[11] Judge Leon significantly discounted the probative value of defendant and third-party statements offered by the government to show that post-merger AT&T would gain increased bargaining leverage.[12] Instead, the judge gave significant weight to: (i) the defendants' expert's analysis of "evidence relating to three prior

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5 U.S. v. AT&T, Inc., 310 F. Supp. 3d 161, 184 (D.D.C. 2018).

6 *Id.* at 217. *See* Final Judgment, U.S. v. Comcast Corp., No. 11-cv-106 (D.D.C. Sept. 1, 2011) (Leon, J.).

7 U.S. v. AT&T, Inc., No. 18-5214, slip op. at 18 (D.C. Cir. Feb. 26, 2019) (hereinafter "Op.").

8 310 F. Supp. 3d at 199.

9 *Id.*

10 *Id.* at 190, 254.

11 *Id.* at 199.

12 *Id.* at 204-14.

instances of vertical integration in the video programming industry" that did not result in increased content costs; and (ii) testimony from vertically integrated programmer-distributors "that the integration of programming and distribution does not affect affiliate negotiations."[13] In light of this evidence, the district court did not credit what it characterized as the "bargaining theory" put forward by the government and its expert,[14] and found several flaws with the inputs into the expert's model.[15]

The government appealed the decision. The DOJ argued in its appellate brief that the district court clearly erred because it disregarded the Nash bargaining theory and other maxims of economics, treated the parties' evidence inconsistently, and improperly discredited the government's economic expert.

The D.C. Circuit's Opinion

The court of appeals affirmed the district court. While noting that "the district court made some problematic statements, which . . . this court cannot ignore,"[16] the court of appeals found that the district court did not commit clear error when it found "that the government failed to present persuasive evidence that [Turner's] bargaining leverage would 'materially increase' as a result of the merger,"[17] and ultimately "did not abuse its discretion in denying injunctive relief."[18]

First, the court addressed the government's argument that the district "court discarded the economics of bargaining" in reaching its conclusion.[19] On this point, it held that "the record shows that the district court 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."[20] According to the court of appeals, "the district court concluded that the theory inaccurately predicted the post-merger increase in content costs during affiliate negotiations."[21] The appeals court cited the defendants' "econometric analysis of real-world data," and wrote that "the district court reached a fact-specific conclusion based on real-world evidence that, contrary to the Nash bargaining theory and government expert opinion on increased content costs, the post-merger cost of a long-term blackout would not sufficiently change to enable Turner

13 *Id.* at 215, 218.

14 *Id.* at 221.

15 *Id.* at 225-41.

16 Op. at 17.

17 *Id.* at 17-18.

18 *Id.* at 34.

19 Brief of Appellant at 37, U.S. v. AT&T, Inc., No. 18-5214 (D.C. Cir. Oct. 18, 2018) (hereinafter "Br. of Appellant").

20 Op. at 19.

21 *Id.* at 21.

Broadcasting to secure higher affiliate fees."[22] The appeals court also cited evidence of the effect of the arbitration agreements offered by Turner.[23]

The appeals court then addressed evidence the district court interpreted as showing that the merged firm would seek broad distribution of Time Warner's content, rather than withhold it. The district court had stated that the evidence showed that "vertically integrated corporations have previously determined that the best way to increase company wide profits is for the programming and distribution components to separately maximize their respective revenues."[24] The government had argued that the district court erred in stating that divisions within a single firm would work separately to maximize each division's profits, because such a finding was contrary to "the foundational [economic] principle of corporate-wide profit maximization"[25] The appeals court disagreed and held that "[t]he district court can be viewed as conveying its understanding that Turner Broadcasting's interest in spreading its content among distributors, [rather than] imposing long-term blackouts, would redound to the merged firm's financial benefit, not that Turner Broadcasting would act in a manner contrary to the merged firm's financial benefit."[26]

Next, the appeals court held that the district court did not clearly err when it found rival distributors' testimony "of little probative value," but favorably cited testimony from Time Warner and another vertically-integrated programming distributor.[27] The appeals court explained this was not error because much of the rivals' testimony was found by the district court to be speculative and lacked "any analysis or factual basis to support key assumptions," whereas the other testimony was based on prior experience.[28]

The appeals court held that it was not clear error for the district court to reject the government's expert's model because the district court found "insufficient evidence" to support inputs into that model.[29] Finally, the appeals court did observe that the district court "misstated" the government's evidence on whether post-transaction price increases would "outweigh . . . cost saving to AT&T's customers."[30] However, the appeals court found that this was "harmless error," because the foundation of the district court's decision

22 *Id.* at 19, 22.

23 *Id.* at 22-23.

24 310 F. Supp. 3d at 222-23.

25 *See* Br. of Appellant at 29.

26 Op. at 27.

27 *Id.* at 30-31.

28 *Id.*

29 *Id.* at 32.

30 *Id.* at 33.

was that costs to rival distributors would not increase.[31] Therefore, that decision "was not based on balancing any price increases against cost savings to consumers." [32]

Significance and Takeaways

This case was the first litigated vertical merger challenge in decades, and, as the court noted in its opinion, some had "urged th[e] court to speak definitively on the proper legal standard for evaluating vertical mergers."[33] However, the court determined that "there is no need to opine on the proper legal standards for evaluating vertical mergers because, on appeal, neither party challenges the legal standards the district court applied, and no error is apparent in the district court's choices."[34]

Nevertheless, as the court noted, "[t]here is a dearth of modern judicial precedent on vertical mergers and a multiplicity of contemporary viewpoints about how they might optimally be adjudicated and enforced."[35] Last November, the Federal Trade Commission (FTC) held a public workshop on vertical merger analysis; and senior government enforcers have recently spoken of the need to revise the agencies' *Non-Horizontal Merger Guidelines*, which are, they admit, out-of-date.[36] Just within the past few weeks, the FTC has twice split on its analysis of vertical deals.[37] While both of those deals ultimately were approved – and, to be sure, the facts in those cases are different from this case – the dissenters wrote at length of their concerns that vertical integration would anticompetitively raise rivals' costs.[38] Within the past several months, the DOJ cleared the vertical integration of Cigna and Express Scripts without conditions, even as

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31 *Id.* at 33-34.

32 *Id.* at 33.

33 *Id.* at 15.

34 *Id.*

35 *Id.*

36 *See, e.g.*, Testimony of Makan Delrahim, Asst. Atty. Gen. for Antitrust, U.S. Dep't of Justice, Before the U.S. Senate Comm. on Judiciary Subcomm. on Antitrust, Competition Policy & Consumer Rights (Oct. 3, 2018) ("we'll probably look at the vertical merger guidelines in the coming future, since those have been in place since 1984, and most of us would not even understand them if we read them today"); D. Bruce Hoffman, Dir., Bureau of Competition, Fed. Trade Comm'n, Vertical Merger Enforcement at the FTC, at 4 n.9 ("the Non-horizontal Guidelines have not been updated since 1984, and do not provide useful guidance for vertical mergers today").

37 *See* Press Release, Fed. Trade Comm'n, FTC Requires Fresenius Medical Care AG & KGaA and NxStage Medical, Inc. to Divest Bloodline Tubing Assets to B. Braun Medical, Inc. as a Condition of Merger (Feb. 19, 2019); Press Release, Fed. Trade Comm'n, FTC Imposes Conditions on Staples' Acquisition of Office Supply Wholesaler Essendant Inc. (Jan. 28, 2019).

38 *See, e.g.*, Statement of Comm'r Rohit Chopra, In the Matter of Sycamore Partners II, L.P., FTC File No. 181-0180 (Jan. 28, 2019); Statement of Comm'r Rebecca Kelly Slaughter, In the Matter of Fresenuis Medical Care, FTC File No. 171-0227 (Feb. 19, 2019).

it maintained its challenge to the AT&T-Time Warner transaction.[39] And in the CVS-Aetna deal, which has both horizontal and vertical elements, the DOJ only required a horizontal remedy.[40] (Judge Leon, who is overseeing the settlement approval process in that case, has expressed questions about the scope of the DOJ's complaint and proposed remedy.)[41]

The upshot is that vertical merger analysis is quite fact-specific, and parties would do well to carefully marshal "real-world" evidence in support of their theories of competitive effect, rather than rely on theory alone. The district court here found "pricing data resulting from prior instances of vertical integration" to be persuasive;[42] and the outcome suggests that such hard empirical evidence can overcome certain prior statements of the parties that may cut against their theory of the case. (Here, the government cited the parties' statements in prior proceedings, which the government claimed aligned with its theory, but the court "could understand that the defendants' [prior] admissions . . . offered little probative support" in light of the parties' "econometric analysis.")[43]

Furthermore, as the agencies themselves recognize, rigorous expert models are often very important;[44] therefore, clear and comprehensive expert testimony which incorporates and is consistent with "real-world" evidence and natural experiments should be a priority.

Finally, as the defendants did here, parties to a challenged deal should also carefully evaluate whether they can propose an enforceable unilateral post-complaint remedy that might undercut the theory of competitive harm the government posits in its complaint, for a court may be willing to credit a condition that the government will not.

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39 *See* Statement of the Department of Justice Antitrust Division on the Closing of Its Investigation of the Cigna–Express Scripts Merger (Sept. 17, 2018). Paul, Weiss represented Cigna in this matter.

40 *See* Competitive Impact Statement, U.S. v. CVS Health Corp., 18-cv-2340 (D.D.C. Oct. 10, 2018).

41 *See* Order to Show Cause, U.S. v. CVS Health Corp., No. 18-cv-2340 (D.D.C. Dec. 3, 2018) (Leon, J.).

42 310 F. Supp. 3d at 215.

43 Op. at 25.

44 *See, e.g.*, Prepared Statement of the Fed. Trade Comm'n Before the U.S. Senate Comm. on Judiciary Subcomm. on Antitrust, Competition Policy & Consumer Rights (Oct. 3, 2018), at 5 ("Qualified experts are a critical resource in all of the FTC's competition cases heading toward litigation.").

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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