THE DISTRICT COURT'S *AT&T/TIME WARNER* DECISION: INSIGHTS INTO THE LAW OF VERTICAL INTEGRATION

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I. INTRODUCTION

Arising out of the first government action to block a vertical merger in over forty years, the District Court's opinion regarding the fate of AT&T's acquisition of Time Warner represented one of the most eagerly anticipated antitrust decisions in quite some time. Not because the law was unsettled. Quite the contrary, the law on vertical integration is widely regarded as being relatively clear, at least by legal standards. The bigger question was whether by opting to proceed with the case, the Justice Department was signaling its intention to adopt a more aggressive posture towards vertical integration. And in the U.S. system, such a change in enforcement policy can only be effective if sanctioned by the courts.

Those hoping for a major sea change in the law of vertical integration must have been sadly disappointed. Although I found some personal gratification from the fact that the first major law review article that I authored as a law professor was the first source cited in the main body of the opinion (p. 7),[2] at first blush, the decision appeared to turn on case-specific assessments of the credibility of testimony offered by competitors and expert witnesses that would appear to have few implications for future cases.

Closer inspection reveals that the District Court's opinion does more than that. Its careful restatement of the law confirms and reinforces key aspects of the law. In addition, the detailed application of the law to the facts of the case yields new insights that did not exist before.

II. THE NATURE OF MUST-HAVE CONTENT

One of the most interesting aspects of the District Court's decision was its rejection of claims that the merged firm would harm competition by making it harder for other cable companies, satellite companies such as DirecTV and the DISH Network, and other providers of multichannel video (defined in the statute as Multichannel Video Programming Distributors or "MVPDs") to obtain access to must-have content. The District Court correctly concluded that in order to state a plausible claim on this basis, the content must truly be essential to an MVPD's survival; it is not enough that the content is simply very popular.

As an initial matter, it is hard to see Time Warner's programming as essential. The alleged must-have nature of Time Warner content is undercut by the factual record in the case, which showed that the DISH Network suffered only negligible losses when CNN went dark during the 2014 midterm elections (p. 77), DISH Sling has succeeded despite not having content that many regard as must-have (such as CBS and Showtime), testimony from Charter and DISH acknowledging that Time Warner content was not essential, and the inability to back up their bare assertions with any analysis led the Court to discount competitor claims of essentiality (pp. 75-78).

A review of Time Warner's flagship channels reveals that each faces significant competition that raises serious questions about their status as must-have. Although the testimony placed CNN in second place among cable news channels (p. 31), recent media reports indicate that CNN has since slipped to third place and is facing increasingly intense competition at a time when the number of people relying on television as their primary source of news is declining. Time Warner's general interest channels, such as TBS and TNT, face vigorous competition from similar networks transmitting old movies and off-network syndication, such as USA (which outranks TBS in number of viewers), Nickelodeon, and Lifetime, and the inputs necessary to create are readily available on the open market.[3] Finally, the District Court found that Time Warner's premium movie channels, such as HBO and Cinemax, have never reached more than 30 percent of available households, have long faced vigorous competition from channels such as Showtime, Starz, and Epix, and are increasingly facing competition from new over-the-top ("OTT") video providers (which the District Court calls "virtual MVPDs") such as Netflix, Hulu and Amazon Prime (pp. 23, 34 n.10, 35, 167).

The ready availability of substitutes for each of these types of programming renders claims of essentiality untenable. Instead, the District Court correctly concluded that must-have programming is a marketing phrase used by virtually every cable channel to convince others that its content is popular (p. 77). As such, the District Court's opinion is likely to make both litigants and courts more careful about casual attempts to characterize content as must-have.

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2 All in-text page references are to the slip opinion in *United States v. AT&T Inc.*, Civil Case No. 17-5211 (RJL) (D.D.C. June 12, 2018), *available at* https://ecf.dcd.uscourts.gov/cgi-bin/show_public_doc?2017cv2511-146.

3 Christopher S. Yoo, *Vertical Integration and Media Regulation in the New Economy,* 19 Yale J. on Reg. 171, 230 (2002).

III. THE FOCUS OF MERGER-SPECIFIC HARMS

Even if content were so popular with consumers as to become essential for an MVPD's success, the courts have long recognized that turning popularity into a source of antitrust liability risks having the perverse effect of penalizing firms that were too successful in satisfying their consumers. Such a result would run afoul of *Alcoa's* hoary maxim, "The successful competitor, having been urged to compete, must not be turned upon when [it] wins."[4] Moreover, as the Supreme Court recognized in *Trinko*, the desire to become so popular as to become dominant "is not only not unlawful; it is an important element of the free-market system" so long as it is the result of "'growth or development as a consequence of a superior product, business acumen, or historic accident.'" Indeed, "The opportunity to charge monopoly prices—at least for a short period—is what attracts 'business acumen' in the first place; it induces risk taking that produces innovation and economic growth."[5] In other words, popularity may be the result of competition on the merits, which is precisely what the antitrust laws are designed to promote, not deter.

Simply put, unless accompanied by some anticompetitive practice, successful product, process, and business model innovations that place one party in a superior bargaining position are something to be celebrated, not penalized. This risk of dampening procompetitive activity is one of the major reasons why the courts rejected Philip Areeda and Donald Turner's proposal to impose antitrust liability on "no-fault monopoly."[6]

Thus, even if Time Warner's channels were truly must-have content, that fact would not by itself provide a basis for blocking the merger. Indeed, the District Court repeatedly recognized that whatever special appeal that Time Warner's channels have would exist regardless of whether the merger were permitted to go through or not (p. 78). That is another way of saying that the mere fact that particular content may be essential does not raise merger-specific harms that justify antirust intervention. Blocking the merger would require some finding that vertical integration somehow enhanced the merged company's ability to exploit the bargaining leverage provided by must-have content.

The District Court did spend considerable time evaluating and ultimately rejecting the claim that the merged company would refuse to license Time Warner content to other MVPDs. The opinion acknowledged that content blackouts are bad not just for MVPDs, but also for cable networks, whose profitability depends on their ability to secure wide distribution. On balance, the District Court found that the merged company would not find it profitable to deny any MVPD access to Time Warner content (pp. 72, 156, 160). Indeed, the government's expert conceded as much, a fact that the District Court saw fit to point out on six separate occasions (pp. 72, 82, 97, 117, 152, 165 n.57).

This dynamic underscores the extent to which that cable networks and MVPDs are channel partners whose interests are both partially cooperative and partially adversarial. Every link in a vertical chain of production shares a common interest in maximizing the value of the entire chain. Once the surplus has been maximized, all actors in the chain have the inherently adversarial incentive to claim as much of that surplus as possible. As an abstract matter, the iteration should allow the long-run benefits from maximizing overall value to dominate the short-run benefits of claiming more of the surplus. But some industries fall into the unfortunate trap of permitting the short-run adversarial interests to dominate the long-run cooperative interests. This is particularly unfortunate because in almost all cases, the parties are eventually able to agree on a deal. Indeed, the District Court found that Time Warner has always been able to reach agreement with MVPDs eventually and that there has never been a long-term blackout of Time Warner content (p. 72). The District Court also found that the 2011 vertical merger between Comcast and NBC Universal did not lead to any attempts at foreclosure (p. 106).

Faced with the impossibility of supporting a claim that the merged company would cut other MVPDs off from access to Time Warner content, the government took a different tack. It argued that the merged company would gain increased bargaining leverage from the fact that some of the subscribers who dropped an MVPD because of the lack of Time Warner content would migrate to DirecTV. Losses in viewership resulting from the deadlock would be partially offset by increased revenue from new DirecTV subscribers diverted from the other MVPD. This increased leverage would allow Time Warner to strike a deal at a higher price (p. 73).

It is hard for antitrust courts to identify what constitutes an improper exercise of bargaining power. As the District Court noted, both sides should expect these negotiations to be tough and for both sides to threaten to impose a blackout (pp. 71-72, 157). Indeed, deadlock is a not uncommon feature of any arm's length negotiation. The District Court found unconvincing competitors' generic statements of enhanced

4 *United States v. Aluminum Co. of Am.*, 148 F.2d 416, 430 (2d Cir. 1945).

5 *Verizon Commc'ns Inc. v. Law Offices of Curtis V. Trinko, LLP,* 540 U.S. 398, 407 (2004) (quoting *United States v. Grinnell Corp.*, 384 U.S. 563, 570-71 (1966)).

6 3 Phillip Areeda & Donald F. Turner, Antitrust Law 63-67 (1978).

bargaining power that were not backed by any economic analysis to justify those bare assertions (pp. 83, 94-96). Any supposed increase in bargaining power is further limited by consumers' increasing propensity to cut the traditional pay television cord altogether and to subscribe to OTTs like Netflix (pp. 23, 138). The claims of enhanced bargaining power were further undercut by testimony from rivals stating that they did not believe that the merger would increase Time Warner's bargaining leverage (p. 93). Indeed, as the District Court noted, no actor conceded that it would feel compelled to agree to any possible price increases demanded by the merged company (p. 98).

Such speculative assertions that the vertical integration would lead to an increase in price do not constitute proof of a likelihood of a substantial lessening of competition. Such an assessment is further complicated by the fact that successful competition on the merits can also increase a company's bargaining power. Imposing antitrust liability on this basis risks dampening the incentives for firms to create those improvements or simply protecting the merged company's "rivals from any and all competitive pressures they would experience should the merger go through" (p. 92).

IV. THE NEED TO SHOW BOTH THE ABILITY AND THE INCENTIVE TO HARM COMPETITION

Another key implication of the District Court's decision results from its emphasis that an antitrust violation requires a showing of both the ability and the incentive to engage in anticompetitive activity. Both showings are necessary, although neither by itself is sufficient.

Consider the District Court's discussion of the potential impact of preventing competing MVPDs from obtaining access to Time Warner programming. The District Court recognized that the merged company had the ability to do so, but found that it would find any such course of action to be unprofitable. As the opinion noted, "evidence indicating defendant's recognition that it could be possible [to withhold content from its MVPD rivals] is a far cry from evidence that the merged company is likely to do so" (p. 90). Simply put, showing that the merged company has the *ability* to foreclose their competitors says nothing about their *incentive* to do so. Both showings are necessary to state a plausible case of consumer harm (p. 83).

The District Court came to the same conclusion with respect to the claim that the merged company would unilaterally foreclose OTTs. Although the merged company might have the ability to withhold content (or alternatively force OTTs to take more content than they would like), it was likely to find such practices inconsistent with its business strategy to promote wider availability of content over wireless devices (pp. 153-57). With respect to the possibility of tacit collusion with Comcast to harm OTTs, the government's expert asserted that the possibility existed, but conceded that he had no way to assess how likely it was to occur (p. 159). The District Court again found no credible proof that the merged company would have the incentive to reduce distribution of Time Warner programming (p. 160). If anything, the merged company had the incentive to encourage OTTs rather than to quash them (pp. 161-63). And even if it did withhold Time Warner content, the fact that many OTTs have been able to survive without other programming properties generally regarded as must-have raises questions about whether such content blackouts will have the effect predicted by the government (pp. 75-77, 151 n.52). Indeed, OTTs are thriving despite the fact that no OTT carries every channel that most people regard as must-have programming.

The District Court drew the same conclusion with respect to the government's third theory of liability, which argued that the merged company might withhold HBO-based promotions from rivals. The District Court found that the merged company's heavy dependence on HBO-based promotions suggested that it lacked any incentive to engage in this type of behavior (pp. 166-67). In addition, the absence of any proof that customers leaving other MVPDs would subscribe to DirecTV raised serious questions about the merged company's ability to pursue this strategy. Indeed, the District Court concluded that such customers were just as likely to forego subscribing to an MVPD altogether and simply sign up for Netflix (pp. 167-68). The opinion thus concluded that the merged company would possess neither the incentive nor the ability to use withholding HBO-based promotions to harm competition (p. 169).

All of these analyses reinforce the importance of evaluating whether a firm has both the ability and the incentive to engage in the allegedly anticompetitive conduct. All too often, the presence of a large, dominant firm is considered enough to tempt imposing antitrust liability without sufficient inquiry into whether the practice being challenged would actually be profitable. Fortunately, the economic incentives facing large companies tend to align with the maximization of consumer welfare in the vast majority of cases.

V. THE INCREASING IMPORTANCE OF EMPIRICAL ANALYSIS

One of the most striking aspects of the District Court's opinion is the emphasis it places on empirical analysis. With respect to industry testimony, the District Court disregarded simple statements of opinion offered by competitors because they were not backed up by any economic analysis (pp. 92-94). Clearly, the District Court regarded some empirical foundation as a necessary precondition for testimony to carry any weight.

The importance of empirical analysis is even more apparent in the opinion's discussion of the expert testimony offered by both sides. The District Court recognized (and the government's witness conceded) that event studies were superior to model-based approaches (p. 100). Event studies of three recent vertical mergers in the cable industry (News Corp.'s 2003 acquisition and 2008 divestiture of DirecTV, Time Warner's 2009 spinoff of its cable assets, and Comcast's 2009 acquisition of NBC Universal) conducted by the defendant's witness found no statistically significant evidence of price increases for programming and found some evidence that prices had decreased and that the industry had become even more competitive since those transactions (pp. 101-02). These findings are consistent with the findings of a recent survey of the peer-reviewed empirical literature on vertical integration co-authored by a scholar who would later serve as FTC Chief Economist during the Obama Administration.[7] This survey found that, aside from a few isolated studies, the weight of the evidence indicates that "under most circumstances, profit-maximizing vertical-integration decisions are efficient, not just from firms' but also from the consumers' points of view," a conclusion that the researchers did not have in mind when they began their review of the evidence.[8] Somewhat surprisingly, the government's expert did not conduct his own analysis of this evidence (p. 100).

For testimony based on economic models, the District Court's opinion makes crystal clear that the parameters going into such models must have a strong empirical foundation (pp. 118-45) and must take into account real-world institutional features, such as long-term contracts, that can limit the merged company's ability to raise prices (pp. 146-48, 163-64). Once these are taken into account, the empirical evidence indicated that consumer prices might actually go down (p. 147).

The District Court's skepticism of the government expert's model is an apt illustration of the distinction between *exemplifying theory* and *generalizing theory* drawn by MIT economist Franklin Fisher.[9] Generalizing theory proceeds from fairly general assumptions to establish broad propositions that apply under a wide range of circumstances. Exemplifying theory, in contrast, employs specialized assumptions to show what can happen under particular circumstances and produce results that are quite sensitive to small changes in assumptions. As such, the proper role of exemplifying theory is to advance possibility theorems demonstrating that certain outcomes can exist, under appropriate circumstances, of course. Without a solid empirical foundation showing how likely those preconditions are to be met, exemplifying theory only identifies what *can* happen without shedding much light on the likelihood that the predicted possibility theory might actually come true.[10]

The District Court's desire for a strong empirical basis for the parameters used as inputs into the theoretical model is understandable. Theorems come in the form of "if *P*, then *Q*." Such models can be very good at demonstrating that certain outcomes are possible. Indeed, theoretical models proved invaluable to rebutting calls by the Chicago School to make vertical integration and vertical restraints *per se* legal by showing the existence of circumstances under which vertical integration could harm consumers. As the District Court carefully explained, however, antitrust liability depends on probabilities; mere possibilities are insufficient (pp. 83, 90). Thus, such a model's ability to explain the likelihood of *Q* depends entirely on how likely *P* is true as a factual matter.

The highly stylized nature of most modern theoretical models makes careful study of the empirical basis of parameters particularly important. For example, Michael Whinston's influential model of how tying can induce foreclosure depends on a very specific relationship between the size of the outside market and the minimum efficient scale of the tied product, arguing that tying can leave stand-alone producers with too little volume to compete as cost-effective producers. The relevant ranges for these parameters are quite exacting. If the outside market is larger than the minimum efficient scale for the tied product, the model fails to yield foreclosure. In addition, Whinston acknowledges that his model does not consider whether tying might give rise to efficiencies even though the necessary conditions for his model are the ones under

7 Francine Lafontaine & Margaret Slade, *Vertical Integration and Firm Boundaries: The Evidence,* 45 J. Econ. Lit. 629 (2007).

8 *Id.* at 680.

9 The discussion that follows is based on Christopher S. Yoo, *Network Neutrality, Consumers, and Innovation,* 2008 U. Chi. Legal F. 179, 249-56.

10 Franklin M. Fisher, *Games Economists Play: A Noncooperative View,* 20 RAND J. Econ. 113, 117-18 (1989).

which the elimination of double marginalization would yield significant welfare benefits,[11] which in the case of *AT&T/Time Warner* was recognized by the government's expert to be in excess of $350 million (pp. 57, 66-67, 109). Like the model offered by the government's expert in the *AT&T/Time Warner* case, Whinston's model represents a classic example of exemplifying theory in that both employ stylized assumptions that are quite sensitive to small changes in parameters (pp. 138-39, 147). In both cases, any proper assessment of the economic desirability of a vertical practice depends on sound parameterization on the model's inputs and assessment of the potential efficiencies.

VI. THE PROBLEMS WITH DUAL-AGENCY REVIEW

A final striking feature of this case, the difference between this merger review process and that of Comcast's acquisition of NBC Universal, is the absence of extensive conditions on the merger. Although the District Court approved the *AT&T/Time Warner* merger without conditions, the order approving the *Comcast/NBC Universal* merger contained many restrictive provisions. It required *Comcast/NBCU* to license content to OTT competitors and refrain from retaliating against any channel that licensed its content to a competing MVPD. The merged company had to surrender its management rights to OTT competitor Hulu. Lastly, the merger clearance required *Comcast/NBCU* to comply with the Federal Communications Commission's ("FCC's") 2010 Open Internet Order until 2018 even though the courts struck down that order in 2014 for exceeding the agency's authority. The merger review process thus allowed the FCC to impose a restriction on *Comcast/NBCU* that fell outside of its statutory authority.[12]

The FCC's Order clearing the merger was even more onerous, requiring *Comcast/NBCU* to comply with over one hundred merger conditions that spanned twenty-six pages. These included commitments to expand Spanish-language programming; expand local news, local public affairs, and other public interest programming; enter into cooperative agreements with locally focused non-profit news organizations; increase children's programming; develop an on-demand platform for public access, educational, and governmental content; add 1,500 miles to its broadband network; upgrade service in at least six rural communities; provide 600 courtesy broadband account locations in schools, libraries and other community institutions in underserved areas; and create a Broadband Opportunity Plan to promote broadband adoption in low-income homes. In addition, the Order included agreements between *Comcast/NBC Universal* and the Independent Film & Television Alliance to allocate $6 million per year for four years to fund independent productions and agreements with leaders of Asian American, African American, and Hispanic organizations that included commitments on governance, supplier, workforce, and program diversity by creating Diversity Advisory Councils, adding a Hispanic member to Comcast's Board of Directors, and other measures.

While many of these conditions have laudable intentions, none of them even plausibly addressed harms created by the merger. Instead, they are the product of the fact that the *Comcast/NBCU* merger required the transfer of licenses issued by the FCC, in contrast to the *AT&T/Time Warner* merger, which did not. This subjected *Comcast/NBCU* to the FCC merger review process, which applies a public interest standard that includes factors that go beyond those applied by antitrust law and that places the burden of proof on the merging parties to show benefits instead of on the government to show harm. Moreover, in contrast to Justice Department merger review, FCC review is not subject to any statutory time limits, and FCC's self-imposed regulatory guidelines are routinely tolled and extended. The lack of a statutory deadline and the placement of the burden of proof on the merging parties have the effect of forcing the merging parties to offer supposedly voluntary commitments until the FCC is satisfied. To the extent that the conditions are styled as voluntary commitments, they are immune from judicial review.[13]

The contrast between the two mergers provides an eloquent illustration of the problems with dual agency review. Not only is much of the review duplicative; the nature of the FCC review process is characterized by longer delays and enables the agency to impose a wide range of conditions unrelated to the merger that sometimes exceed the agency's authority. Rather than pursue general regulatory requirements that would address a problem with respect to the entire industry, merger conditions impose a one-off restriction that affects only a single actor simply because it had a merger pending and is typically insulated from judicial scrutiny.

11 Michael D. Whinston, *Tying, Foreclosure, and Exclusion,* 80 Am. Econ. Rev. 837 (1990).

12 For other similar examples, see Christopher S. Yoo, *Merger Review by the Federal Communications Commission: Comcast-NBC Universal,* 45 Rev. Indus. Org. 295, 311-12, 314 (2014).

13 *Id.* at 298-99, 311-13.

VII. CONCLUSION

In the end, the District Court's opinion did more than resolve the case in a factbound way. A close reading reveals that it confirms certain key understandings of the law of vertical integration. Moreover, its application of that law to the facts of the case extended aspects of the law in ways that provide new insights into the scope of the law. Although the District Court decision will likely soon be superseded by the decision of the Court of Appeals, reading it still yields many worthwhile insights upon which practitioners may continue to draw for years to come.