CPI's Europe Column Presents:

Preserving Innovation Competition in the Digital Era: *"Killer Acquisitions"*

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A phenomenon that has lately raised increasing concern within the antitrust community is the issue of the so-called "*killer acquisitions*." By this term, the law and economics literature refers to acquisitions by incumbent firms of promising companies, able to potentially and significantly threaten their position, with the objective of eliminating future competition. Indeed, the topic has become quite in vogue, as it can be noticed by the numerous references to it in the conference organized by DG Competition in January 2019: "Shaping competition policy in the era of digitization" (hereinafter, "the DG Competition conference").[2]

However, even if this issue is lately a recurring one, it is barely developed from a substantive standpoint and commentators often base their reasoning on mere intuitions. In fact, there is only one notable contribution on killer acquisitions and it is written by academics in economics or management science.[3] In addition, that contribution only focuses on the pharmaceutical industry, which means that the issue of killer acquisitions in the digital sector has not been addressed in the competition law literature. Typically, conferences and academic research have only incidentally addressed the topic in the context of broader competition policy discussions.

Against this background, two expert panel reports have been published recently with the purpose of providing recommendations on whether to adapt the competition law rules to digitization: the Furman and the European Commission Special Advisers' Reports.[4] Both reports have tried to shed some light into the debate on killer acquisitions, hence these proposals will be frequently referred to in the ensuing paragraphs.

The Majority of Incumbents' Acquisitions are Pro-Innovative "*Bolt-on Acquisitions*" or, at the very Least, Neutral to Competition

The DG Competition conference left attendees with the impression that incumbent digital firms are systematically eliminating future innovation competition by acquiring and "*killing*" promising incipient companies; nevertheless, this view greatly mischaracterizes a far different reality. In fact, it is safe to assume the vast majority of incumbents' acquisitions are pro-innovative or, at the very least, neutral to competition.

Most of the acquisitions by incumbents do not have the objective of eliminating competition but, on the contrary, greatly foster innovation by exploiting synergies and/or incorporating complementary technologies and capabilities. In this sense, numerous academics have found that if the acquirer owns a complementary technology, the merger will increase the innovation performance of the resulting undertaking,[5] so long as these are carefully integrated.[6] In this way, companies often "bolt-on" the newly acquired complementary technologies and capabilities to their current offerings in order to enhance their value proposition. These "*bolt-on acquisitions*" pervade the merger record of big tech firms. For instance, Google acquired and integrated into its Google Maps offer plenty of companies with complementary technologies and capabilities ranging from traffic and map analysis to location-based analytics and local recommendations/reviews apps – like ZipDash, Where2, Keyhole Inc, Endoxon,

ImageAmerica, Quiksee, Zagat, Clever Sense, Skybox Imaging, Urban Engines, etc. – which have allowed it to substantially improve its value proposition. Among these, only *Google/Waze* generated any competition concerns.

In this respect, it was surprising to see that some voices at the DG Competition conference called the process by which start-ups are launched for the very purpose of being bought (what is called in economics "*entry for buyout*") "*bad innovation*." This view greatly mischaracterizes the whole process, firstly, because it wrongly assumes that the acquired companies are in a position to challenge the incumbent's position, whereas very frequently that is not the case and, secondly, because it obviates the fact that most of these companies rely on the financial, reputational, and organizational support of the acquirer to be able to innovate successfully. As the EC Report acknowledged:

> […] mergers between established firms and start-ups may frequently bring about substantial synergies and efficiencies: while the start-up may contribute innovative ideas, products and services, the established firm may possess the skills, assets and financial resources needed to further deploy those products and commercialize them. Simultaneously, the chance for start-ups to be acquired by larger companies is an important element of venture capital markets: it is among the main exit routes for investors and it provides an incentive for the private financing of high-risk innovation.[7]

This process should be viewed through a different lens: the products developed by incumbent digital firms spur significant innovation around them which is often later incorporated to make even better products. It is therefore clear that the majority of acquisitions by big tech companies are pro-innovative or at the very least, neutral to competition. Nevertheless, it is equally reasonable to assume that some transactions would have risen serious concerns provided that, as Jean Tirole said at the conference, "it is too easy for incumbents to buy out their future rivals" and they have all the incentive to do so. Most, however, have inevitably gone unnoticed because they are not caught by the current EU merger regime.

How to Catch Killer Acquisitions under the Current EU Merger Regime?

An important impediment to the competitive assessment of these transactions is that they often escape the EU Merger Regulation (hereinafter, the "EUMR") notification requirements. The main reason is that the notification thresholds only take into consideration the turnover of the merging parties. In contrast, "start-ups attempt [first] to build a successful product and attract a large user-base without much regard for short term profits: they hope either to be acquired or to begin monetizing their user base at a relatively late stage."[8]

Until now, some of the transactions that escaped the EUMR thresholds were caught through the referral mechanism of the EUMR.[9] This was, for instance, the case of the *Apple/Shazam* merger which was referred to the Commission by the Austrian authority, together with some other national competition authorities, in accordance with Article

22(1) EUMR. However, this mechanism is limited in effect given that the Commission is only able to look at the implications of the concentration in the Member State territory of the referring authorities. Other acquisitions, like *Facebook/WhatsApp*, were referred to the Commission by the notifying parties under Article 4(5) EUMR. In the latter case, unlike Article 22(1) EUMR, the Commission acquires full jurisdiction over the transaction.

Nevertheless, the referral system has proven to be insufficient considering that some very controversial transactions never reached the Commission's hands, including *Facebook/Instagram* and *Google/Waze*. Both of these transactions were instead caught by the UK merger framework and scrutinized by the Office of Fair Trading.[10] For this reason, and following Austria and Germany's lead, many have called for a reform of the EUMR to adopt transaction value-based thresholds. This proposal shows several important problems, as highlighted by the EC Report,[11] and that is why the Special Advisers suggested taking stock from the Austrian and German reforms before drawing conclusions at EU level. The position taken by the expert panel on this topic can be considered to be rather conservative since no other alternatives were examined.

For its part, the Furman Report made the recommendation to "[require] digital companies that hold a "*strategic market status*" to make the CMA aware of their intended acquisitions [to] allow the CMA to determine in a timely manner which cases warrant more detailed scrutiny."[12]According to the report, the strategic market status would be granted to those companies holding market power over a strategic bottleneck market.[13] However, in my view, this approach is somewhat deficient in that not all the firms over whose transactions we should worry about operate as gatekeepers of a market. This may be true, for instance, for Google or even Amazon, but it is certainly not for Apple, Samsung, or Facebook, among others. Furthermore, Google may be a gatekeeper in general search, but it is definitely not in other relevant markets.[14] For these reasons, I consider that a broader definition of "*strategic market status*" based on a more comprehensive approach similar to the assessment of (super)dominance would constitute a more viable alternative. This approach would thus also take into consideration other factors, such as particularly high market shares and substantial barriers to entry in the form of strong network effects, availability of large data sets, and intellectual property rights *inter alia*. In this regard, even if this would force incumbents to notify all of their transactions, big corporations have more than enough resources to do so and, in any case, the burden could be minimized by establishing an *ad hoc* fast-track procedure.[15] Lastly, by opting for this alternative, we would also be able to catch alleged killer acquisitions in other industries where the value of the transactions is not that high, like in the pharmaceutical sector.

Finally, another – practically uncharted – alternative would be to apply Article 102 TFEU directly to these transactions, as the Commission did in *Tetra Pak I*. In that case, the General Court found that:

> the acquisition by an undertaking in a dominant position of an exclusive patent license for a new industrial process constitutes an abuse of a dominant position where it has the effect of strengthening the undertaking's already very considerable dominance of a market where

> very little competition is found and of preventing, or at least considerably delaying, the entry of a new competitor into that market, since it has the practical effect of precluding all competition in the relevant market.[16]

This case shares many traits with the killer acquisition scenario and its rationale could perfectly be extrapolated here. There is nothing that would impede the application of Article 102 TFEU to these cases and it would provide the Commission with a more complete enforcement toolbox. In this respect, it would be necessary, as proposed by the Furman Report in the UK, to establish a digital markets unit "with new powers available to impose solutions and to monitor, investigate and penalize non-compliance"[17] that would enable the Commission to speed up enforcement and, therefore, to achieve an adequate level of deterrence in an area where dynamism is key.[18] The proposal for the establishment of a dedicated unit for digital markets has been backed by officials of different competition authorities[19] and it has recently been endorsed by the UK government.[20]

In light of the above, a combination of an *ex ante* control mechanism requiring those undertakings holding a "*strategic market status*" to notify their transactions, in parallel with an *ex post* application of Article 102 TFEU by a dedicated digital markets unit, could constitute a solution to the problem of catching these transactions.

Substantive Assessment

Apart from establishing a system to catch these transactions, their competitive assessment should also be rethought. The analysis will vary depending on whether the acquirer and the target have directly overlapping products.

A. Horizontal Mergers: Transactions with Overlap

In these cases, the assessment will be relatively simple since the acquisition would not pass the substantive test of the EUMR, provided that there are no relevant countervailing efficiencies, as it would lead to a significant impediment of effective competition ("SIEC test"): acquiring a promising start-up would strengthen the incumbent's dominant position by protecting it from a potential challenger. As noted above, the Commission used the same rationale in *Tetra Pak I*. In that case, the General Court upheld the Commission's finding that Tetra Pak's acquisition of the only relevant competing technology constituted an abuse of dominance, as it had the effect of strengthening the undertaking's already very considerable position in a market where very little competition was to be found. In my view, this should have been the case of the *Facebook/Instagram* merger.[21]

B. Non-Horizontal Mergers: Transactions without Overlap

Conversely, when the target company has fringe products or services and operates in an adjacent market, it will be significantly more complicated to assess the competitive effects of the transaction. The problem arises because, in principle, the Commission will have to prove to the requisite legal standard that the target is a potential competitor in the core market of the acquirer.

1. The Proposals from the Expert Panels in the Furman and EC Reports

In that sense, the Furman Report laid down a much-discussed proposal[22] according to which the CMA should be bolder and "more economically oriented" by changing the evidentiary standard from a "*balance of probabilities*"[23] to a "*balance of harms*." In essence, the idea would be to relax the evidentiary standard in mergers with a "potentially very large scale of lost benefits." That would mean that, when the magnitude of the harm is considerable, the evidentiary standard would be lowered from a "more likely than not" to a "realistic prospects"[24] standard. According to the Furman Report, this should be amended in spite of some "occasional rare false positive along the way." The latter is an inaccurate premise given that, as explained above, the vast majority of acquisitions of small firms by large digital incumbents are pro-innovative bolt-on acquisitions or, at the very least, neutral to competition. Most worryingly, such an evidentiary asymmetry[25] would leave the competition authorities with an incommensurate level of unbacked (and thus, incontestable) discretion. As the famous astronomer Carl Sagan once put it, "extraordinary claims require extraordinary evidence" or, equally, "what can be asserted without evidence can be dismissed without evidence."[26]

For its part, the EC Report circumvented the issue of establishing the requisite evidentiary standard by suggesting a novel theory of harm based on a "broader view of the position of the incumbent in a *market for the digital ecosystem*."[27] The harm would derive from the strengthening and enclosing of a particular "user space," by expanding the network effects from one platform to another. However, this novel theory of harm displays some critical flaws. First, even if it would have possibly worked for transactions such as *Facebook/Instagram* and *Google/Waze*,[28] a range of cases would nevertheless escape where (i) there is no extension of the network effects; or (ii) in the event of the extension, users are not locked in because the value derived from the network effects is not the primary reason to stay on the platform. Second, it is also difficult to grasp what the actual harm is in this theory: are users, as a consequence of the acquisition, paying a higher price, enjoying lower quality or less choice? If anything, it seems that users stay on the newly created platform because they derive more value from the strengthened network effects. It is for these reasons that, in my view, the proposal of the EC Report is equally unsatisfactory.

2. A Sounder Alternative: Applying the Innovation Competition Approach

An "*innovation competition*" approach would provide the necessary tools to tackle the intricate problem at stake. In a series of cases ranging from *Novartis/GlaxoSmithKline*[29] and *GE/Alstom*[30] to *Dow/DuPont*[31] and *Bayer/Monsanto*,[32] the regulated framework of those industries (pharmaceutical, industrial manufacturing, and agro-chemical) allowed the Commission to capture restrictions of competition at an early stage, that is, before any anticompetitive effect on the relevant market could be predicted with enough certainty. This means that, if we managed to extrapolate the innovation competition methodology to digital transactions, it would not be necessary to establish a "potential competition" relationship to the (highly demanding) requisite legal standard. Instead, we would need to show that the target company is pursuing *a discernible innovation objective,* consisting in creating a potentially competing product from an adjacent market and that it has the *ability* and *incentive* to carry it through. In this respect, it would not matter if it is still uncertain *ex ante* whether the developing product will end

up actually competing with the existing product or whether it will eventually reach the market at all: as it was established in the abovementioned cases, the object of protection would be *the incentive of the parties to innovate,* that is, *the innovative process per se*.[33]

The EC Report has explicitly rejected the application of the innovation spaces methodology to digital transactions on the ground that in the digital sector, as opposed to the heavily regulated pharmaceutical and agro-chemical industries, R&D does not take the form of a distinct and well-structured process with clearly identifiable research poles.[34] In contrast with this statement, the Commission has managed to shift outside of the pipelines framework in the last agro-chemical cases *Dow/DuPont* and *Bayer/Monsanto* to define innovation spaces at the level of *early R&D efforts*. As shown in these cases, a holistic approach, including an analysis of (i) *essential resources* (e.g. large data bases, specialized and expensive hardware, access to financing, engineering skills, and computation power *inter alia*[35]); (ii) *capabilities* (as a function of the company's skillset, strategy, governance structure, and past behavior[36]); (iii) *patent overlaps*; (iv) *investment plans of both merging parties* setting innovation targets; and (v) *internal documents of the acquirer* with post-merger divestment plans, should allow the Commission to define the relevant *innovation space* and perform an innovation competition assessment in digital transactions, despite the absence of pipelines.[37] As introduced above, the underlying approach would entail a classic two-step test, where the Commission has to prove that the target company displays both (1) the *ability*;[38] and (2) the *incentive* to pursue an *innovate project* capable of threatening the incumbent's position.[39] In this regard, instead of a classic innovation competition setup of overlapping pipeline products or early R&D efforts (as in *Dow/DuPont*), the situation would present an existing product that is being threatened by an incoming innovative product in the pipeline (as was the case in *Medtronic/Covidien*[40]).

In fact, the EC Report later accepted that this approach may "obviously" be relevant in some circumstances where essential resources or capabilities are present, to nuance next that, precisely because of the lack of them at an early stage, the methodology would rarely be applicable to the acquisition of incipient start-ups.[41] This point seems unconvincing because, in order to raise any competition concerns, early and targeted acquisitions must be triggered for a specific reason. There must be something particularly valuable about the target company, in terms of assets or capabilities, for the incumbent to find it promising to acquire it (usually for an important sum) instead of just replicating the technology or product in question. If no essential assets or capabilities are detected, on the contrary, the transaction should logically not raise any competition concerns at all. In that case, the acquisition by the incumbent firm would be merely speculative (or just neutral to competition) and any competition concern raised by the authorities would be equally unsubstantiated. This should not, however, constitute an argument for the non-application of the innovation competition approach.

The innovation competition approach would provide the Commission with a more suitable methodology to deal with the killer acquisitions issue in situations where the target company operates in an adjacent market, as opposed to the proposals of the Furman Report, based on a "*balance of harms*" approach, and the EC Report, based on

a novel theory of harm entailing a "broader view of the position of the incumbent in a *market for the digital ecosystem*." The expert panel of the EC Report should have paid more careful consideration to the innovation competition alternative and it should not have dismissed it that promptly. By extrapolating this methodology to digital transactions, the Commission's assessment of innovation concerns would also be consistent across the board in merger control.

Final Conclusions

The issue of "*killer acquisitions*" has recently attracted increasing concern within the antitrust community, in particular, because of their important harm to digital innovation. However, the topic has barely been developed from a substantive standpoint. This paper has taken the opportunity to explore and propose solutions to the different problems in dealing with killer acquisitions. In this regard, the main findings are:

- The majority of small firm acquisitions by incumbents do not have the objective of eliminating competition but, on the contrary, greatly foster innovation by exploiting synergies and implementing complementary technologies. These are the so-called "*bolt-on acquisitions*." However, there are good reasons to suspect that digital incumbents may have at times eliminated potential competition by means of "*killer acquisitions*."
- The current enforcement system should be adapted to include a combination of (i) an *ex ante* control requiring those undertakings to which the "*strategic market status*" has been granted to notify their transactions; and (ii) an *ex post* application of Article 102 TFEU by a dedicated digital markets unit.
- Finally, the Commission should adopt the innovation competition approach, as developed in the line of cases *Novartis/GlaxoSmithKline*, *GE/Alstom, Dow/DuPont*, and *Bayer/Monsanto,* to the substantive assessment of alleged killer acquisitions.

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[2] January 17, 2019: https://webcast.ec.europa.eu/shaping-competition-policy-in-the-era-of-digitisation.

[3] C. CUNNINGHAM, F. EDERER & S. MA, "Killer Acquisitions," (2018), SSRN.

[4] J. FURMAN et al., "Unlocking digital competition. Report of the Digital Competition Expert Panel," March 2019 (hereinafter, "Furman Report"); J. CRÉMER, Y. DE MONTOJYE & H. SCHWEITZER, "Competition policy for the digital era," April 2019 (hereinafter, "EC Report").

[5] B. CASSIMAN et al., "The Impact of M&A on the R&D Process: An Empirical Analysis of the Role of Technological and Market Relatedness," (2005) 34, *Research Policy,* p. 197. Other contributions in the same sense include Gans & Stern (2003), Arora & Gambardella (2010), Arora et al. (2014).

[6] https://hbr.org/2016/07/the-problem-of-bolt-on-acquisitions-in-a-digital-world, accessed 14 June 2019.

[7] EC Report, p. 116. See, in the same vein, Furman Report, pp. 49-50.

[8] *Ibid*, p. 116.

[9] The referral mechanism of the EUMR consists, in essence, of a system which allows for transactions that would normally have to be assessed by the Commission to be transferred to the National Competition Authorities ("NCAs") and *vice versa*. The relevant provisions of the EUMR are Arts. 4(5) and 22, for referrals from the NCAs to the Commission, and Arts. 4(4) and 9, for referrals from the Commission to the NCAs.

[10] Since 2014, the OFT has been replaced by the Competition and Markets Authority (the "CMA").

[11] EC Report, p. 119.

[12] Furman Report, p. 18.

[13] *Ibid*, p. 16.

[14] Why should we scrutinise then its acquisitions in other relevant markets where it does not have that gatekeeping position?

[15] This notification procedure would specifically apply to firms holding the "*strategic market status*" qualification, it should be more summary than the simplified procedure already foreseen by the Commission and it should focus on providing the necessary elements to make a preliminary substantive assessment, that is, information relating to essential assets and capabilities of the target (in connection with this, read *infra*), as well as the rationale of the transaction, expected results, pro-innovative effects, etc.

[16] Judgment of July 10, 1990, *Tetra Pak Rausing SA v. Commission,* Case T-51/89, EU:T:1990:41, see summary.

[17] Furman Report, p. 10. Albeit, this proposal was made in that report solely in relation to an *ex ante* control function.

[18] This would also help the Commission to deal effectively with all the new notifications arriving from those companies holding "*strategic market status*" as suggested above.

[19] https://globalcompetitionreview.com/article/1193812/ex-ante-regulation-is-crucial-in-digital-sector-uk-and-australian-enforcers-agree?utm_source=linkedin&utm_medium=social&utm_campaign=news, accessed June 13, 2019.

[20] https://www.gov.uk/government/speeches/pm-speech-opening-london-tech-week-10-june-2019, accessed June 13, 2019. Theresa May: "And I am pleased that Professor Furman has today agreed that he will advise on the next phase of work on how we can implement his recommendation to create a new Digital Markets Unit."

[21] In that case, the OFT dismissed with a strikingly shallow level of analysis the potential competition issue in relation to the supply of social network services (see OFT Decision of August 22, 2012, Case ME/5525/12 – *Facebook/Instagram*, pars. 22-24, 29). The highlighted differences in functionalities should have been considered negligible in the eyes of the users and, in that sense, a strong case could have been made for a broader market from the users' side (or even for *attention markets*).

[22] Also discussed within the DG Competition conference by one of the Special advisors who co-authored the EC Report (H. SCHWEITZER), but then it was never included in the final version probably because of the problems that will be described next.

[23] The Commission has a very similar legal standard: "significant likelihood" (Horizontal Merger Guidelines, par. 60).

[24] That the negative effects are merely "likely to occur."

[25] It is a basic evidentiary principle that the size of one's claims should be directly proportional to the evidence put forward.

[26] The so-called Hitchens's razor.

[27] EC Report, p. 122.

[28] https://digital.hbs.edu/platforms-crowds/google-maps-doubles-network-effects-stave-off-formidable-competition/, accessed March 15, 2019.

[29] Commission Decision of January 28, 2015, Case M.7275 – *Novartis/GlaxoSmithKline Oncology Business*.

[30] Commission Decision of September 8, 2015, Case M.7278 – *General Electric/Alstom.*

[31] Commission Decision of March 27, 2017, Case M.7932 – *Dow/DuPont.*

[32] Commission Decision of March 21, 2018, Case M.8084 – *Bayer/Monsanto.*

[33] In the range of pharmaceutical and agro-chemical mergers, the Commission has repeatedly established that it is irrelevant to the innovation competition assessment that the innovative process is highly uncertain, that is, the fact that *ex ante* the relevant developing products may still have a low probability of getting to the market or, even if they do, of ending up competing against each other in the future. Instead, what matters is that if two competing innovation projects fall in the same hands as a result of a merger, the incentive to innovate will disappear and, consequently, the projects will be stopped. Unless the incentives of the parties to keep innovating are maintained, the potential innovative outcome at stake will never take place (provided that the resulting company does not have other incentives to still carry it through).

[34] EC Report, p. 125.

[35] W. KERBER, "Competition, Innovation, and Competition Law: Dissecting the Interplay," (2017) 42, *MAGKS Joint Discussion Paper Series in Economics*, pp. 15-16.

[36] J. G. SIDAK & D. J. TEECE, "Dynamic Competition in Antitrust Law," (2009) 5(4), *Oxford Journal of Competition Law and Economics,* pp. 614-617.

[37] Similar suggestions have been made by M. BOURREAU & A. DE STREEL, "Digital Conglomerates and EU Competition Policy," (2019), p. 27-28; W. KERBER, *supra* note 35, pp. 15-16.

[38] Entailing the analysis of the first three elements.

[39] Including the two last factors *inter alia.* This means that the Commission would not necessarily have to rely on finding explicit plans in the internal documents of the parties. If it can build the case why it may be attractive for the target company to compete against the core business of the acquirer, the innovation competition relationship would be established and the incumbent would actually be constrained by the target.

[40] Commission Decision of November 28, 2014, Case M.7326 – *Medtronic/Covidien*, pars. 247-250.

[41] EC Report, p. 125.