EXPANDING THE MERGER NARRATIVE: A RESPONSE TO SOKOL

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Professor D. Daniel Sokol's prolific scholarly contributions to the field of antitrust are essential reading and his recent article on *Vertical Mergers and Entrepreneurial Exit*[1] is no exception. In it, Professor Sokol draws upon a rich understanding of strategic management, entrepreneurship policy, and the start-up-funding ecosystem to offer a novel account of the rationales for and effects of certain merger and acquisition (M&A) activity. Amidst the fierce debates currently being waged over antitrust policy, the nuanced insights offered by Professor Sokol are particularly welcome. We seem to find ourselves living in a world in which nuance is in short supply.[2]

Professor Sokol juxtaposes his article against the rising popular backlash targeting large incumbent tech companies like Facebook, Google, and Amazon.[3] In particular, Professor Sokol frames his thesis as a response to arguments that "vertical mergers by such firms (acquisitions of smaller tech companies) are to be treated with particular suspicion . . . ."[4] Professor Sokol's own descriptive thesis is, roughly speaking, that antitrust enforcement in dynamic markets may prevent firms from achieving certain efficiencies, and also runs the risk of chilling capital investment and start-up activity. Normatively, Professor Sokol concludes that status quo vertical merger policy is optimal.

The article begins by identifying the relevant question to be answered: "[W]hat sort of inference should we use—one that presumptively *favors* or *disfavors* vertical mergers?"[5] As Professor Sokol explains, the debate over vertical merger policy within mainstream antitrust circles has largely focused on empirical industrial-organization literature.[6] Professor Sokol broadens that rather narrow lens to include the robust business strategy literature.[7] That literature offers two particularly salient insights for

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1. D. Daniel Sokol, *Vertical Mergers and Entrepreneurial Exit*, 70 FLA. L. REV. 1357 (2018).

2. *See, e.g.*, John Herrman, *Does This Moment in History Call for More 'Nuance,' or Less?*, N.Y. TIMES MAG. (Oct. 16, 2018), https://www.nytimes.com/2018/10/16/magazine/does-this-moment-in-history-call-for-more-nuance-or-less.html [https://perma.cc/BQ9G-W59U] ("Something has been lost in our politics, [moderates] say: our civility; our ability to communicate, reason, deliberate. What they mourn above all, though, is the loss of nuance.").

3. Sokol, *supra* note 1, at 1358–59 ("This backlash against tech—and the use of antitrust as a tool against large tech companies—has attracted support from left- and right-wing populist forces.").

4. *Id.* at 1359.

5. *Id.* at 1360 (emphasis added).

6. *Id.* at 1361–62.

7. *Id.* at 1362.

antitrust policymakers. First, incumbent firms tend to be relatively poor at developing new products, but relatively good at developing innovative ways of producing or delivering products.[8] Start-ups, on the other hand, tend to be good at product innovation—for many, that is their *raison d'être*—but relatively bad at scaling up production and distribution.[9] Thus, an incumbent's acquisition of a start-up may allow the incumbent to leverage its own unique advantages to capitalize on the start-up's product innovation. Second, founders frequently plan for, and structure their start-ups around, exit via acquisition.[10] Being acquired by an incumbent represents a liquidity event for founders and funders alike.[11] Entrepreneurs are able to exit armed with sufficient cash to fund their next venture (or perhaps a comfortable retirement). This type of entrepreneurial exit is posited as an integral part of the start-up ecosystem.

These are intriguing insights, not yet well-recognized by the antitrust community. Antitrust discourse in general tends to lack a robust account of the incentives underlying corporate mergers and acquisitions. Instead, the prevailing view seems to be Manichean: mergers are either "procompetitive" or "anticompetitive."[12] In other words, many antitrust analysts seem to categorize mergers as either "good," by which they mean efficiency-enhancing, or "bad," by which they mean market-power-enhancing.[13] The consensus seems to be that most mergers are good.[14] This is especially true of vertical mergers.

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8. *Id.* at 1372–73.

9. *Id.*

10. *Id.* at 1357.

11. *Id.*

12. *See, e.g.*, Elizabeth M. Bailey, *Roundtable Interview with Joseph Farrell and Carl Shapiro*, 9 ANTITRUST SOURCE, Feb. 2010, at 1, 8 ("When it comes to predicting the effects of a merger, I think we are on solid ground and best served by making predictions based on how the incentives of the firms will change as a result of the merger, be that procompetitive or anticompetitive."); Richard S. Markovits, *An Ideal Antitrust Law Regime*, 64 TEX. L. REV. 251, 287 n.53 (1985) ("[J]oint ventures, horizontal mergers, or refusals to deal may be either procompetitive or anticompetitive.").

13. Of course, as Williamson famously argued, some mergers present a perceived trade-off between increased internal efficiency (good) and enhanced market power (bad). *See* Oliver E. Williamson, *Economies as an Antitrust Defense: The Welfare Tradeoffs*, 58 AM. ECON. REV. 18, 18–19 (1968). As Glick and Salop point out, presenting a firm's lower internal costs as something that analysts should "trade-off" against lower prices to consumers is (to put it mildly) rather curious, at least if one takes the consumer-welfare standard seriously. *See* Mark Glick, *The Unsound Theory Behind the Consumer (and Total) Welfare Goal in Antitrust*, 63 ANTITRUST BULL. 455, 489 (2018); Steven C. Salop, *Question: What is the Real and Proper Antitrust Welfare Standard? Answer: The True Consumer Welfare Standard*, 22 LOY. CONSUMER L. REV. 336, 337 (2010).

14. *See, e.g.*, David L. Meyer, *Merger Enforcement is Alive and Well at the Department of Justice*, U.S. DEP'T OF JUST. (Nov. 15, 2007), https://www.justice.gov/atr/speech/merger-enforcement-alive-and-well-department-justice [https://perma.cc/XW6M-Q82M] ("We

The impulse to classify mergers and acquisitions using this simple dichotomy is perhaps understandable. Introductory antitrust casebooks tend to present mergers as either efficiency-enhancing or (rarely) a mechanism for enhancing market power.[15] In practice, merger review presents a binary choice—at the end of the day, a given deal must either be approved or challenged.[16]

As Professor Sokol points out, however, mergers can occur for reasons other than internal productive efficiency or the enhancement of market power.[17] One of those heterodox reasons is entrepreneurial exit: a company's founder may be more interested in cashing out than in undertaking the difficult work of scaling up production and distribution facilities.[18] Professor Sokol is correct to conclude that antitrust analysts should account for entrepreneurial exit as a potential deal driver.

That said, the broad project of building out the antitrust community's understanding of merger incentives is far from complete. Entrepreneurial exit is not the only possible explanation for M&A activity that has gone overlooked by the antitrust enterprise. The "hubris hypothesis" provides another: many deals appear to be the result of managers' desire to engage in empire-building[19] or simply pad their own pockets.[20] Underlying such acquisitions is a classic principal–agent problem.[21] Given a lack of

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recognize that most mergers are procompetitive, or at least competitively neutral, and we will not interfere with those transactions.").

15. *See, e.g.*, E. THOMAS SULLIVAN ET AL., ANTITRUST LAW, POLICY, AND PROCEDURE: CASES, MATERIALS, PROBLEMS 858 (7th ed. 2014) ("Why did so many mergers occur after, rather than before, the passage of the Sherman Act? One possibility is that economies of scale made business consolidations efficient . . . . Another argument is that the Sherman Act's prohibition of agreements among competitors was merely an excuse for firms to achieve anticompetitive market positions by merger rather than by contract."); *id.* at 841–43 (identifying but dismissing leverage, foreclosure, and forcing as theories of welfare harms that can result from vertical mergers); *id.* at 845 ("There are literally hundreds of ways that firms can lower their costs or provide better costs by integrating vertically . . . . [M]ost industries can find ways to reduce some costs by engaging in a certain amount of vertical integration.").

16. *See, e.g.*, John M. Newman, *Antitrust in Zero-Price Markets: Applications*, 94 WASH. U. L. REV. 49, 71 (2016) ("In merger cases brought under Clayton Act § 7, courts [decide] whether a transaction will 'lessen competition' . . . ."). The option of obtaining a consent decree offers something of a middle ground, of course, but even a consent decree requires a complaint, and a complaint must allege harm to competition.

17. *See* Sokol, *supra* note 1, at 1371

18. *See id*; *see also* Dawn R. DeTienne, *Entrepreneurial Exit as a Critical Component of the Entrepreneurial Process: Theoretical Development*, 23 J. BUS. VENTURING 203, 204–05 (2010) (defining entrepreneurial exit).

19. *See* CLAIRE HILL ET AL., MERGERS AND ACQUISITIONS: LAW, THEORY, AND PRACTICE 15 (1st ed. 2016).

20. *See* Yaniv Grinstein & Paul Hribar, *CEO Compensation and Incentives: Evidence from M&A Bonuses*, 73 J. FIN. ECON. 119, 119 (2004).

21. *See, e.g.*, Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323, 323 (1986).

effective shareholder oversight, managers (agents of shareholders) can be expected to use M&As to enrich themselves at shareholders' expense. Of course, where this results in an unjustifiably high acquisition price, one side effect is that the target firm's shareholders may benefit. As a result, the hubris hypothesis is not mutually exclusive of Professor Sokol's entrepreneurial-exit narrative: an acquirer's overbidding may naturally incentivize a start-up's founders to take the bid. But a transaction driven by managerial hubris may well destroy, rather than create, societal value, even where it allows a windfall to the target firm's entrepreneurial founders. The policy implications of the hubris hypothesis are not cut-and-dried, but one could argue they weigh in favor of increased antitrust enforcement. For present purposes, merely noting the existence of such deal drivers is enough—the crucial point is that the prevailing understanding is still far from complete.

As a result, the policy implications that Professor Sokol derives may be premature. He argues for "a different set of policy inferences" to govern vertical mergers as compared to horizontal mergers.[22] His preferred presumption is that vertical mergers are "competitively beneficial or neutral."[23] That presumption is, of course, already in place—vertical mergers have long been all but immune from serious antitrust challenges.[24] Professor Sokol goes on to make the normative claim that "the merger plaintiff . . . should bear the burden of demonstrating a net harm to consumers."[25] Yet this is also already true. Essentially, then, Professor Sokol's article can be read as a defense of the status quo.

The status quo, it bears emphasizing, is quite friendly to defendants relative to earlier periods of antitrust history.[26] Vertical mergers and

22. Sokol, *supra* note 1, at 1377.

23. *Id.* at 1378.

24. In fact, it was somewhat notable that, in his ruling on the DOJ's challenge to AT&T and Time Warner's proposed vertical merger, Judge Leon "concluded that vertical mergers are not per se legal." Wayne Dale Collins et al., *DOJ Loses First Vertical Merger Suit Brought in Decades as Federal Judge Approves AT&T's Acquisition of Time Warner*, SHERMAN & STERLING (June 14, 2018), https://www.shearman.com/perspectives/2018/06/att-acquisition-of-time-warner [https://perma.cc/NX6J-YV8F]. Of course, Leon nonetheless found for the defendants, and the Second Circuit affirmed his decision. Edmund Lee & Cecilia Kang, *U.S. Loses Appeal Seeking to Block AT&T-Time Warner Merger*, N.Y. TIMES (Feb. 26, 2019), https://www.nytimes.com/2019/02/26/business/media/att-time-warner-appeal.html [https://perma.cc/2L3H-JX4Y].

25. Sokol, *supra* note 1, at 1377–78.

26. *See, e.g.*, Jonathan B. Baker & Carl Shapiro, *Reinvigorating Merger Enforcement*, *in* HOW THE CHICAGO SCHOOL OVERSHOT THE MARK: THE EFFECT OF CONSERVATIVE ECONOMIC ANALYSIS ON U.S. ANTITRUST 244 (Robert Pitofsky ed., 2008) (quoting Dennis K. Berman, *How to Assess 2007's M&A Activity*, WALL ST. J. (Jan. 16, 2007, 11:59 PM) https://www.wsj.com/articles/SB116890180735777039 [https://perma.cc/HM8B-6N4R] (internal quotation marks omitted)).

restraints of trade are all but *per se* legal.[27] Aside from hardcore cartels, only blatantly anticompetitive horizontal mergers seem to attract serious scrutiny. Even those are frequently cleared, sometimes after divestitures,[28] but sometimes without condition.[29]

Left unchallenged by Professor Sokol's article is the foundational question of whether the current *laissez faire* status quo is a good starting point. If so, then recognizing entrepreneurial exit as a new and additional procompetitive justification for vertical mergers would suggest either maintaining the status quo (as Professor Sokol proposes) or raising the bar even higher for antitrust plaintiffs.

But there is at least some reason to doubt that the status quo's descriptive claims and normative positions are accurate or optimal. First, the descriptive claim that most mergers are procompetitive may well be incorrect.[30] Blonigan and Pierce describe the results of a recent empirical study as follows: "On average, we find that mergers do not have a discernible effect on productivity and efficiency. . . . By contrast, we find substantial average increases in the amount that firms mark up prices over cost following a merger, ranging from 15% to over 50% . . . ."[31] Indeed, many empirical studies indicate that "mergers . . . actually reduce the real profitability of acquired business units . . . ."[32] without creating value for acquirers or their shareholders.[33] Second, it is far from clear that the current defendant-friendly approach to merger review is producing optimal results. Kwoka, for one, offers compelling evidence of systematic

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27. Michael A. Carrier, *The Real Rule of Reason: Bridging the Disconnect*, 1999 B.Y.U. L. REV. 1265, 1280–82 (reporting that defendants win the overwhelming majority of litigated rule-of-reason antitrust cases).

28. *See* Naomi Kresge, *Bayer Closes Monsanto Deal to Cap $63 Billion Transformation*, BLOOMBERG NEWS (June 7, 2018, 10:38 AM), https://www.bloomberg.com/news/articles/2018-06-07/bayer-closes-monsanto-deal-to-cap-63-billion-transformation [https://perma.cc/6S8U-SMM2].

29. *See* John M. Newman, *Complex Antitrust Harm in Platform Markets*, ANTITRUST CHRON., May 2017, at 6–7 (criticizing the FTC's decision to clear Zillow's acquisition of Trulia without condition); Kurt Wagner, *Here's Why Facebook's $1 Billion Instagram Acquisition Was Such a Great Deal*, VOX (Apr. 9, 2017, 3:16 PM), https://www.vox.com/2017/4/9/15235940/facebook-instagram-acquisition-anniversary [https://perma.cc/PG9U-LTQC].

30. *See* Bruce A. Blonigen & Justin R. Pierce, *Mergers May Be Profitable, but Are They Good for the Economy?*, HARV. BUS. REV. (Nov. 15, 2016), https://hbr.org/2016/11/mergers-may-be-profitable-but-are-they-good-for-the-economy [https://perma.cc/W6VV-UG6T].

31. *Id.*

32. Richard E. Caves, *Mergers, Takeovers, and Economic Efficiency*, 7 INT'L J. INDUS. ORG. 151, 167 (1989).

33. *See, e.g.*, Ulrich Steger & Christopher Kummer, *Why Merger and Acquisition (M&A) Waves Reoccur—The Vicious Circle from Pressure to Failure*, 2 STRATEGIC MGMT. REV. 44, 44 (2008) ("[M]ost M&As are considered to be unsuccessful.").

underenforcement.[34] In sum, the status quo may not be the best starting point for designing policy.

It should also be noted that the possibility of entrepreneurial exit would not necessarily justify allowing a dominant incumbent to act as the purchaser. The pro-enforcement commentators driving the groundswell of popular support for antitrust enforcement do not propose an absolute ban on M&A activity among all firms.[35] Facebook's purchase of Instagram, Google's purchase of Waze—these were purchases of start-ups by established and arguably dominant incumbents. Did these deals facilitate entrepreneurial exit? Perhaps. But alternative buyers may have offered the same benefits without posing such serious competitive concerns.

Moreover, it is quite possible that allowing existing firms to buy up rival start-ups and trading partners will cause dynamic harm in the medium to long run, even if such acquisitions yield the types of process efficiencies that underlie the entrepreneurial-exit narrative. Start-ups often have unique firm cultures, managerial visions, and ways of approaching traditional market problems.[36] In antitrust parlance, start-ups may be particularly likely to play the role of "maverick," continuing to disrupt the status quo even after their initial, breakthrough product innovations.[37] Allowing such valuable players to be subsumed into the relatively stale environs of an incumbent may cause society to lose out on what might be called "innovations along the way."[38] To illustrate, imagine Yahoo had been allowed to acquire Google in the year 2000. Of course, one cannot know with absolute certainty what the world would look like today had Yahoo, instead of Google, been at the helm of internet search for the past two decades. But it is at least possible—and perhaps probable—that Yahoo would have missed out on more than a few innovations along the way. Losing out on such innovations would leave society immeasurably worse off. Again, the policy implications are not entirely clear, but do not clearly support the hands-off status quo.

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In *Vertical Mergers and Entrepreneurial Exit*, Professor Sokol has made an invaluable contribution to antitrust discourse. The prevailing

34. *See generally* JOHN KWOKA, MERGERS, MERGER CONTROL, AND REMEDIES: A RETROSPECTIVE ANALYSIS OF U.S. POLICY (2015).

35. *See, e.g.*, Lina Khan, *Will Trump's DOJ Crack Down on Massive Vertical Mergers?*, L. & POL. ECON. (Dec. 4, 2017), https://lpeblog.org/2017/12/04/447/ [https://perma.cc/33Z8-N8JQ].

36. *See* Ranhay Gulati & Alicia DeSantola, *Start-Ups That Last*, HARV. BUS. REV., Mar. 2016, at 54, 55–61.

37. U.S. DEP'T OF JUSTICE, FED. TRADE COMM'N, HORIZONTAL MERGER GUIDELINES (2010).

38. John M. Newman, *Antitrust in Attention Markets: Objections and Responses*, 59 SANTA CLARA L. REV. 743, 768 (2020).

antitrust narrative describing why firms merge is overly—and unnecessarily—simplistic. Professor Sokol's work provides an excellent starting point for what should become a broader project, to be taken up by the community as a whole: understanding the multifaceted reasons firms undertake M&As. Accounting for entrepreneurial exit as one such motivator will enrich antitrust law and economics and improve decision-making. Yet there remains important work to be done in this area—and, indeed, on the more foundational questions surrounding the current state of merger enforcement. With that in mind, the popular critique of the antitrust status quo ought to be welcomed by insiders. The marketplace of ideas, like all markets, generally benefits from new entry and increased competition.