THE NATIONAL LAW REVIEW

Published April 6, 2023 | NatLawReview.com

In Reversal of ALJ, FTC Commissioners Order Illumina to Unwind GRAIL Deal

GRAIL reacquisition has been bad practice all around.

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In a unanimous bipartisan decision, the Federal Trade Commission released an opinion Monday (April 3, 2023) finding Illumina's $8 billion acquisition of cancer-screening test maker, GRAIL, is likely substantially to lessen competition in the market for the research, development, and commercialization of multi-cancer early detection ("MCED") tests. With that conclusion, the Commission overturned the decision reached last September by the FTC's own Administrative Law Judge ("ALJ"), D. Michael Chappell, that FTC Complaint Counsel had failed to prove a *prima facie* case against the acquisition.

In its *de novo* review, the Commission also determined Illumina's proposed remedies promising access to rival test-makers were inadequate. The FTC ordered Illumina to divest the GRAIL assets, consistent with the September 2022 decision of the European Commission, which also concluded the deal was anticompetitive and required Illumina to divest GRAIL.

This announcement comes at a particularly inopportune time for Illumina directors and officers. In early March, activist investor Carl Icahn waged a proxy battle seeking to replace at least three directors and CEO Francis deSouza due, in large part, to their role in the botched GRAIL merger. However, counsel for Illumina has announced its intention to appeal the Commission's decision to the Circuit Court of Appeals and to request an expedited schedule. The Commission's divestiture order will be stayed pending any appeal.

Background of the Companies and Initial Challenges to the Merger

Illumina provides a next-generation sequencing ("NGS") platform to analyze genetic material. While other NGS platforms exist, Illumina's platform is well suited for MCED testing of blood samples. Because no competing platform is likely to emerge in the near term, Illumina's NGS platform is an essential input for MCED testing. Illumina created GRAIL in 2015 to market an Illumina-based MCED test. Several other companies are close to offering competing MCED tests, but none has yet entered the market.

In 2017, Illumina spun off GRAIL for roughly $2 billion, retaining a 12% stake. In 2020, Illumina announced its intention to reacquire GRAIL for roughly $8 billion. The reacquisition was opposed by several competition authorities. The FTC commenced a lengthy investigation, following which it filed an administrative complaint challenging the acquisition. After a multi-week trial, ALJ Chappell dismissed the complaint. The FTC Staff appealed to the full Commission and, in a fairly rare instance, the FTC reversed its own ALJ.

The Commissions' Opinion

The Commission's March 31, 2023, opinion first determined that the research, development, and commercialization of MCED tests was the appropriate relevant product market for evaluating the anticompetitive effects of the merger. The is the same relevant market used by the ALJ in its decision.

The Commission then applied two common approaches used by the courts to analyze anticompetitive effects of vertical mergers:

- (i) The *Brown Shoe/Fruehauf* factors, which include the nature and purpose of the transaction, barriers to entry, whether the merger would eliminate competition by one of the merging parties, and the degree of market power that would be possessed by the merged enterprise as shown by the number and strength of competing suppliers and purchasers.

- (ii) The "ability/incentive standard," which focuses on whether the merger would increase the ability and incentive of the merged firm to foreclose rivals from sources of supply or from distribution.

Under the *Brown Shoe*/*Fruehauf* factors, the Commission determined "the nature and purpose of the acquisition tend to support a likelihood of anticompetitive effects" given Illumina's planned use of GRAIL (the specifics of which were largely redacted) and because the merger involves a sole-source supplier taking ownership of a downstream customer. It determined the deal would increase barriers to entry in the MCED testing market because entrants would have to obtain a necessary input from and provide commercially sensitive information to a competitor.

Finally, the Commission concluded the merger would give Illumina significant market power in the MCED testing market given GRAIL's dominant position in the market and Illumina's role as the sole suitable NGS platform. Therefore, the Commission determined the FTC made out a *prima facie* case of anticompetitive effects under the *Brown Shoe*/*Fruehauf* framework.

Under the ability/incentive standard, the Commission determined Illumina, as the only provider of NGS, has the ability to harm rival MCED test companies. And, due to the acquisition of GRAIL, Illumina would have a strong incentive to harm competition in this market because the combined company would generate significantly more profits by eliminating GRAIL's rivals. The Commission also clarified that, contrary to the ALJ's holding, the FTC need not show Illumina increased both its ability and incentive to harm competition as a result of the merger. If this were the rule, then downstream acquisitions by monopoly platform providers would be exempt from antitrust scrutiny given that such platform providers always have the ability (although typically not the incentive) to harm competition in the downstream market. Therefore, the Commission determined the FTC made a *prima facie* case of anticompetitive effects under the ability/incentive standard.

Finally, the Commission considered Illumina's rebuttal arguments and constitutional defenses, finding that Illumina failed to rebut the FTC's showing of anticompetitive effects through their arguments concerning entry, merger efficiencies, or their Open Offer of platform access. It then found that Illumina's constitutional defenses lacked merit. Accordingly, the Commission concluded the acquisition violated Section 7 of the Sherman Act and Section 5 of the FTC Act.

Transatlantic Harmony

The FTC's opinion harmonizes enforcement efforts with the European Commission ("EC"), which in July 2021 initiated its own in-depth investigation. Parties were supposed to refrain from closing their deal under EC rules until the investigation is complete, but the parties consummated the acquisition in August 2021 anyway. This led the EC to issue an interim order preventing Illumina from integrating GRAIL. On

September 6, 2022, the EC announced it would prohibit the transaction and required Illumina to divest Grail. Illumina has responded and a final and binding order from the EC is expected in the coming weeks.

Bad Practice, All Around

The saga of the GRAIL reacquisition has been bad practice all around, starting with Illumina, which has squandered billions of dollars on a risky transaction that could cost it hundreds of millions more. In 2021, Illumina took a $3.9 billion impairment charge, implying a value of roughly half the acquisition price one year later. Illumina has also been forced to fund GRAIL operationally, which is reportedly costing Illumina $800 million annually. In addition, by defying the EC's hold-separate rule, Illumina could face more than $450 million in fines. If the acquisition is terminated, Illumina could owe GRAIL a substantial termination fee.

It is not inconceivable that the Commission's opinion may face headwinds in the Court of Appeals, although it is usually granted significant deference. Ordinarily a platform monopolist will understand the benefits of internalizing complementary efficiencies, meaning that it serves the platform operator's interest to promote and maintain fully competitive markets for complementary products. If the platform operator doesn't do so, the company will fail to internalize the benefits of the complementary markets. Economic research recognizes several situations in which platform operators exert anticompetitive control over complementary markets against their own interests. One of them is corporate incompetence. This appears to the crux of the FTC's case against Illumina, *i.e.*, that management is not sophisticated enough to maintain efficient and open access to its platform to rival MCED testing firms. But the Commission's (unredacted) order does not say so expressly, nor does it discuss the specific evidence leading to the conclusion that Illumina is more likely than not to seek to impair competition in the complementary MCED testing market.

Nonetheless, the Commission clearly believes that Illumina management intends to maximize profits by acquiring GRAIL and eliminating competition in the MCED testing market. But, if so, Illumina's management would be ignoring the fact that the company will maximize profits (and, thus, shareholder value) by optimizing modularity of its platform through fully competitive complementary markets, not by excluding rivals from them. This is fodder for dissenting shareholders: Had Illumina's management understood the true economic power of their platform, they would never have sought to reacquire GRAIL in the first place, and, upon doing so, would never have given the FTC the idea that they cannot be trusted to be good stewards of a competitive complementary market for Illumina-based MCED testing.

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