ANTICOMPETITIVE ASPECTS OF MARKET-SHARE DISCOUNTS AND OTHER INCENTIVES TO EXCLUSIVE DEALING

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The traditional analysis governing exclusive dealing arrangements has focused on a manufacturer's *requirement* that its distributors deal *exclusively* with it. In recent years, however, some manufacturers have begun to use subtler arrangements in which incentives replace requirements and partial exclusivity replaces total exclusivity. For example, rather than requiring absolute exclusivity, a manufacturer simply may give a more favorable price to customers who purchase more than a certain percentage of their requirements from the manufacturer. Such arrangements, commonly called "market-share discounts," raise two questions: First, how should antitrust law assess the competitive implications of such arrangements? Second, does the law of exclusive dealing prevent antitrust from reaching these agreements, given that they appear on their face to involve neither "exclusive dealing" nor "requirements"?

This article argues that: (1) market-share discounts structured to produce total or partial exclusivity should be judged according to the same economic principles that govern exclusive dealing; and (2) the case law, properly construed, permits such discounts to be condemned under the Sherman Act or FTC Act if they produce anticompetitive effects without counterbalancing procompetitive effects.

The discussion leading to these two conclusions is divided into three principal parts. The first part reviews the traditional rule of reason

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treatment for exclusive dealing contracts, using examples from recent government enforcement actions. The next part examines the economics of partial exclusivity and of discounts structured to create incentives to deal exclusively or nearly exclusively. The final part considers the legal standards applicable to arrangements that fall short of requiring complete exclusive dealing.

I. PRINCIPLES AND ENFORCEMENT WITH RESPECT TO TRADITIONAL FORMS OF EXCLUSIVE DEALING

As the Supreme Court announced in *Continental T.V., Inc. v. GTE Sylvania Inc.*,[1] courts must analyze nonprice vertical restraints under the rule of reason. The Federal Trade Commission applied such a rule of reason analysis to permit an exclusive dealing arrangement in *Beltone Electronics Corp.*,[2] which followed a few years later.

Beltone promoted the hearing aids it manufactured by running print advertisements in publications aimed at senior citizens. The reader could clip coupons contained in these advertisements to send to the firm and learn more about its products. Beltone received these coupons, compiled lists of sales leads organized by geographic area, and sent the lists to dealers in those areas. The dealers then called on the potential customers and provided on-site demonstrations, fitting, and similar services. In devising this system, however, Beltone recognized that certain risks could arise if its dealers also sold other brands of hearing aids—they would have an incentive to sell the brands that maximized their own profits, which might be the brands of manufacturers that did not bear the cost of advertising and promoting. Beltone, therefore, used exclusive dealing arrangements to protect its own investment in advertising and promotion. The Commission began its assessment of these agreements by explaining that "proper analysis of exclusive dealing arrangements should take into account market definition, the amount of foreclosure in the relevant markets, the duration of the contracts, the extent to which entry is deterred, and the reasonable justifications, if any, for the exclusivity."[3] The Commission ultimately upheld the restrictions,[4] in part because they played an important role in promoting interbrand competition.[5]

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[1] 433 U.S. 36 (1977).

[2] 100 F.T.C. 68 (1982).

[3] *Id.* at 204.

[4] *Id.* at 218.

[5] The type of efficiency that appears to have been present in the *Beltone* case corresponds to the argument set forth in Howard P. Marvel, *Exclusive Dealing*, 25 J.L. & ECON. 1 (1982).

Generalizing beyond *Beltone,* exclusive dealing contracts can offer several broad types of efficiencies. These may include giving dealers an incentive to devote themselves wholeheartedly to the success of a brand;[6] giving manufacturers an incentive to support and invest in the success of their dealers, knowing their sales will not be diluted by *inter*brand free riding from other brands in the store; providing better tools for quality control; and providing better tools for the protection of trade secrets and trademarks.[7]

Unfortunately, vertical restraints can also be used to raise prices to consumers and to create or enhance market power. Standard Oil was a classic example. In obtaining its monopoly position, Standard Oil used vertical contracts with railroads to cartelize the railroad industry, which it then used to create market power in oil refining.[8]

Exclusive dealing arrangements are most likely to threaten competition in one of two ways: the arrangements can either facilitate collusion[9] among competitors, or they can facilitate exclusion by allowing a firm to raise its rivals' costs in order to give it the power to increase its price. Exclusive dealing contracts may facilitate *collusion* when they help competitors overcome the obstacles they face in attempting to maintain prices above competitive levels. For example, one way cartels fall apart is that some members may give secret selective discounts for particular contracts.[10] Suppliers may combat this problem by each, in parallel,

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[6] Marvel disputes the rationality of this efficiency justification. *See id.* at 3–5.

[7] *See* Richard M. Steuer, *Exclusive Dealing in Distribution,* 69 CORNELL L. REV. 101, 124 (1983). Whether these effects are actually efficiency-producing in a particular case will, of course, depend on the factual circumstances. For example, a firm that has a current monopoly of a properly defined market by virtue of a patent that expires in five years could not justify a twenty-year exclusive dealing contract with all the distributors (assuming that barriers to entry into distribution exist) by arguing that the arrangement gives distributors the incentive to devote themselves wholeheartedly to the success of the firm's products. Transparently, the monopolist's objective in such a situation would be to extend its monopoly past the point at which the patent confers it, and no exclusive would be necessary to induce distributors to focus on the firm's products for the simple reason that the firm faces no current competition in any event.

[8] *See* Elizabeth Granitz & Benjamin Klein, *Monopolization by "Raising Rivals' Costs": The* Standard Oil *Case,* 39 J.L. & ECON. 1 (1996).

[9] It is common to refer to "facilitating collusion," and we will follow that usage here. More accurately one might call it "facilitating coordinated interaction," since no explicit collusion is required to produce the anticompetitive effect. *Cf.* U.S. Department of Justice and Federal Trade Commission, Horizontal Merger Guidelines (1992) § 2.1, *reprinted in* 4 Trade Reg. Rep. (CCH) ¶ 13,104, at 20,573–76.

[10] The three well-known elements that allow competitors to raise prices or collude are: (1) coordinating on a particular form of conduct, such as fixing a price; (2) detecting cheating on the unlawful agreement; and (3) punishing those that engage in such cheating. For a thoughtful survey of coordination and collusion, see Jonathan B. Baker, *Two Sherman Act Section 1 Dilemmas: Parallel Pricing, the Oligopoly Problem, and Contemporary Economic Theory,*

using exclusive dealing contracts with their own customers. This makes cheating on the cartel more visible, because—at least in the case of differentiated products—it is easier to monitor whether a seller is dealing with a particular buyer than the price at which it is dealing.[11]

Exclusive dealing arrangements can produce exclusionary effects when they enable firms to raise the costs of rivals so that competition can no longer discipline their price increases.[12] For example, if a manufacturer uses long-term[13] exclusive contracts with all or a large fraction of the most efficient distributors, the exclusive contracts could foreclose competing manufacturers from access to an efficient distribution network. If there are barriers to de novo entry into efficient distribution[14] and to the repositioning of less efficient distributors, and if the foreclosure prevents competing manufacturers from achieving economies of scale or otherwise raises their marginal costs, then the foreclosed manufacturers will be unable to discipline the price increases of the dominant firm.[15] If there are no efficiency justifications for the exclusivity clauses that outweigh this

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38 ANTITRUST BULL. 143 (1993). *See also* George J. Stigler, *A Theory of Oligopoly*, 72 J. POL. ECON. 44 (1964).

[11] This effect would be negated, of course, if differences in the price of the intermediate good affected downstream competition to such an extent that the fall in the derived demand for the intermediate good thwarted any effort to raise price. This will frequently not be the case, however. Even where it is the case, collusion might be facilitated if the prices of the final good were more visible than the prices of the intermediate good, thus making "cheating" on the collusive price more visible in that way. Collusion might also be facilitated if a dominant firm were able to target vertical restraints against market participants that deviated from oligopoly pricing—depriving them of critical inputs or distribution as punishment for deviation from the cartel.

[12] *See generally* Thomas G. Krattenmaker & Steven C. Salop, *Anticompetitive Exclusion: Raising Rivals' Costs to Achieve Power over Price*, 96 YALE L.J. 209 (1986).

[13] Even shorter-term exclusive dealing agreements might facilitate collusive effects because they can remove much of a seller's incentive to offer ad hoc discounts. When considering exclusionary effects, the usual concern has been with longer-term agreements, in particular determining whether the number of contracts coming up for renewal at any one time is too small to support efficient entry. There could also be other scenarios of competitive harm, however. For example, entry at an efficient scale might be foreclosed, not by the duration of the contracts, but by the fact that at any given time, even without a long-term contract, customers put to an all-or-nothing choice will find that they must choose the dominant firm rather than the entrant. Indeed, as discussed below, the choice need not even be all-or-nothing: exclusionary effects may result when customers are forced to commit a substantial majority of their purchases to the dominant firm.

[14] Such barriers include anything that keeps a new entrant at the distribution level from enabling the foreclosed manufacturer to escape the effects of its foreclosure. If the new entrant would be unable to achieve economies of scale or scope, it would not constitute effective entry.

[15] Such foreclosure might be thwarted if the distributors could act in a coordinated fashion, thereby causing the manufacturer to pay so high a price to purchase the exclusivity right that the scheme would be unprofitable. However, if customers are numerous and uncoordinated, then the manufacturer will profit from the foreclosure. *See, e.g.*, Eric B. Rasmusen et al., *Naked Exclusion*, 81 AM. ECON. REV. 1137 (1991).

effect, an enforcer should view the exclusivity clauses as an antitrust violation and seek an appropriate remedy.[16]

In recent years the Federal Trade Commission has brought a number of enforcement actions that rely on facilitating collusion, raising rivals' costs, or both as the theory of harm. Important recent cases include *Hale* and *Waterous,*[17] *Toys "R" Us,*[18] and *Mylan Laboratories.*[19] The Department of Justice has also brought an important exclusive dealing case, *Dentsply International.*[20]

Theories of both collusion and exclusion were present in the cases brought by the Federal Trade Commission against Hale and Waterous. These firms were the two leading manufacturers of the specialized water pumps used in fire trucks. According to the FTC complaints, each firm imposed restraints effectively requiring their customers—the makers of fire trucks—to deal exclusively in that manufacturer's pumps. These restraints continued for more than fifty years, governed distribution in about 90 percent or more of the market, and appeared to be anticompetitive in two ways. First, the restraints were collusion-facilitating. With each truck maker committed to working exclusively with one manufacturer or the other, each manufacturer faced little constraint from the other for any given customer's business, and any departure from the tacit market division would be readily detectable. Second, the exclusive agreements also tended to exclude new, third-party pump manufacturers from the market. New entrants could not start with a foothold by serving a small part of the business of several truck makers, and then grow from that base. Indeed, with only 10 percent of the market *not* covered by the agreements, there might not be sufficient business to support a new firm of efficient size. Both companies eventually agreed to consent orders prohibiting their exclusive dealing practices.

A litigated case brought by the FTC is *Toys "R" Us.* This is primarily an exclusion case, involving not a contract to confine sales to one particular

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[16] It is important to note that this raising rivals' costs theory is not the simple "foreclosure" story that underlies some older cases, such as *Standard Oil,* that were hostile to vertical restraints. *See* Standard Oil Co. v. United States, 337 U.S. 293 (1949) (exclusive contracts of defendant accounting for less than 7% of the retailers is sufficient to impose liability where similar contracts cover most of the retailers in the industry). This is not about mere foreclosure of rivals; it is about a foreclosure of rivals that harms competition generally.

[17] Hale Prods., Inc., No. C-3694 (Nov. 25, 1996); Waterous Co., No. C-3693 (Nov. 22, 1996).

[18] No. 9278 (Opinion and Final Order, Oct. 13, 1998) (Swindle, Comm'r, concurring in part and dissenting in part), *appeal docketed,* No. 98-4107 (7th Cir. Dec. 7, 1998).

[19] Case No. 1:98CV03114 (D.D.C.).

[20] United States v. Dentsply Int'l, No. 99-005 (D. Del. 1999).

customer, but rather an agreement by the toy manufacturers to withhold certain types of sales from one class of customers. More specifically, in administrative litigation the Commission found that Toys "R" Us used its power as the largest retailer of toys[21] to enlist major toy manufacturers to engage in a partial boycott of warehouse clubs—discount mass retailers that sell a variety of products, including toys, at very low markups. Toys "R" Us was troubled by the clubs' low prices for two reasons: first, they took some sales away from Toys "R" Us directly; and second, consumers who saw the prices on the same toys at both places would come to be skeptical of the Toys "R" Us claim of having everyday low prices. Instead of competing on the merits to protect its low-price reputation, Toys "R" Us induced toy manufacturers to agree to refrain from selling the same toys to the clubs, except to the extent they were packaged into more expensive, less desirable "club specials" containing two or more toys.

The Commission found that Toys "R" Us had entered into both unlawful vertical arrangements with toy manufacturers and an unlawful horizontal arrangement among toy manufacturers. The vertical arrangements consisted of the series of agreements that Toys "R" Us had extracted from almost all of the major toy manufacturers individually to partially boycott the warehouse clubs. The horizontal arrangement was reached when Toys "R" Us conveyed assurances of compliance with its policies from one manufacturer to another, thus orchestrating a horizontal agreement among several manufacturers to adhere to the desired restrictions.

Another case currently being litigated is *FTC v. Mylan Laboratories, Inc.*[22] Mylan is the country's second-largest generic drug manufacturer. The FTC charged that the firm entered into exclusive licensing and

[21] Although Toys "R" Us's market share was not at a level usually associated with monopoly power, documentary evidence and the testimony of toy manufacturers demonstrated that Toys "R" Us wielded a considerable degree of market power. This evidence is not surprising as a matter of theory. Retail distribution of toys is not a homogeneous good. It is differentiated in both geographic and product space. Especially because toys are often an impulse purchase, a toy manufacturer purchasing retailer distribution services needs to purchase a very wide array of such services. Not only does the manufacturer want distribution in every geographic area, but it wants ubiquity even within a local area. Hence, a toy retailer representing 30% to 40% of the manufacturer's national sales—and higher percentages in many local areas—wields considerable leverage. Nor can the manufacturer easily sponsor entry to replace sales lost by a cutoff from such a retailer. Because many retailing markets are characterized by substantial economies of scope, the manufacturer could only sponsor entry if hundreds or thousands of manufacturers of toys or other products had an incentive to join with it in sponsoring entry. In general, this is not a realistic alternative. Sponsoring expansion of existing outlets is somewhat more realistic, but bumps up against constraints of the alternative retailers' own business plans and the fact that toys, being often an impulse purchase, are likely to encounter diminishing returns to sales effort in any one location.

[22] 62 F. Supp. 2d 25 (D.D.C. 1999).

supply arrangements for the active pharmaceutical ingredients used to make the widely prescribed anti-anxiety drugs, lorazepam, and clorazepate. The FTC found reason to believe that these arrangements had the effect of preventing other generic manufacturers from obtaining competitive sources of supply of the active ingredients, which in turn enabled Mylan to increase prices dramatically. In January 1998 the company raised the wholesale price of clorazepate from $11.36 to approximately $377.00 per bottle of 500 tablets. The FTC charged Mylan and three upstream companies with restraint of trade, monopolization, and conspiracy to monopolize.[23]

A fourth case was recently filed by the Department of Justice against Dentsply, the country's leading manufacturer of artificial teeth. According to the complaint, these teeth are sold through dealers to the next-stage users, which are dental laboratories that incorporate the teeth into finished dentures. Local service is allegedly important in this industry in providing prompt deliveries, returns, and exchanges. Access to a dealer network is, therefore, essential to a manufacturer that wishes to enter the market. The DOJ complaint alleges that Dentsply became the dominant firm at least ten years ago, then barricaded the market against new entry through agreements with its dealers that they would not carry competing premium brands, with the result that 80 percent of all dealers do not do so. The complaint further alleges that new entrants cannot practicably bypass this situation by selling through other dealers that specialize in their own products, due to, among other things, Dentsply's policy of recruiting more dealers than needed, in order to deprive its rivals of effective distribution opportunities.

Thus, within the last several years, there have been a number of enforcement actions, involving both federal antitrust agencies, showing concern for those situations in which exclusive vertical arrangements seem to have led to the anticompetitive horizontal effects of either exclusion or collusion.

II. THE ECONOMICS OF PARTIAL EXCLUSIVITY

An emerging issue in antitrust litigation and counseling is the treatment of more complex forms of exclusive dealing requirements. These can differ from traditional exclusive dealing arrangements in two possible

[23] The *Mylan* case is interesting procedurally as well as substantively. Mylan's exclusive-dealing arrangements appear to have harmed consumers and enriched Mylan and its supplier in such a substantial and quantifiable way that it made little sense for the FTC to seek only an injunction to "go and sin no more." Consequently, the agency brought its case in U.S. District Court, under statutory provisions that invoke the court's equitable powers, to seek disgorgement of at least $120 million in improper profits. The court

ways. First, the arrangements may call for only partial exclusivity rather than complete exclusivity. Second, rather than a contractual requirement of exclusivity, the arrangement may provide only an incentive for complete or partial exclusivity, such as special discounts for buyers that give the seller all or a certain share of their requirements.

Are these kinds of arrangements anticompetitive? Not necessarily, of course, and probably not even usually. The antitrust laws normally encourage discounts and price reductions, and, all other things being equal, partial exclusive dealing contracts are less restrictive and will raise fewer questions than total exclusivity contracts do. But some of these new arrangements clearly have the potential to be anticompetitive.

A. Partial Exclusivity Can Have Anticompetitive Effects

The harm to competition from partial exclusive dealing agreements can take a variety of forms, but the common feature is that the costs of one or more rivals in one way or another (whether in manufacturing, research, purchasing, or distribution) have been raised. This cost increase, in turn, can harm consumers if the affected firms otherwise would have been a constraint on pricing or other dimensions of competition.

To take a simple example, a contract with all of the distributors in a market that 99 percent of their requirements will be served by manufacturer *A* probably will have the same anticompetitive effects as a contract for 100 percent exclusivity. If barriers to entry into distribution are high enough that existing or potential competitors to manufacturer *A* cannot costlessly replace the lost distribution with new outlets, the same potential effects will follow as in the case of total exclusivity:

- If at *A*'s profit-maximizing price a competitor cannot achieve minimum viable scale by serving 1 percent of the market, or by paying a premium for less efficient distribution, then *A* will achieve a monopoly.[24]
- If *A*'s competitors achieve minimum viable scale but still have higher marginal costs than *A*, then *A* may achieve some measure of market power.[25] Higher marginal costs of this sort may result if sponsoring

recently held that the FTC is empowered to seek monetary relief of this sort. 62 F. Supp. 2d at 25 (denying motion to dismiss).

[24] *See* Michael H. Riordan & Steven C. Salop, *Evaluating Vertical Mergers: A Post-Chicago Approach*, 63 ANTITRUST L.J. 513, 554–55 (1995).

[25] *See id.* at 555.

alternative distributors is more expensive than using existing ones.[26] Of course, the competitors could avoid paying to sponsor those alternatives by limiting themselves to 1 percent of the market. But a competitor so limited may not achieve all economies of scale in manufacturing or distribution.[27] Even if it does achieve those economies, the capacity constraint will probably make it profitable for *A* to raise prices notwithstanding the fact that it must cede one percent of the market to an equally efficient competitor.[28]

- The vertical contracts could reduce the expected return on investments by *A*'s competitors in quality improvements or other dimensions of competition. As a consequence, those firms may make fewer such investments and may become less effective competitors to *A* in the long run.[29]

These theories of harm assume that the entrant simply cannot convince some of *A*'s existing distributors to abandon *A* altogether and specialize in the entrant's products instead. There are two general reasons why such conversions might not occur:

- *A*'s contracts with its distributors could be of long duration. In the extreme case, not enough contracts come open for bidding each year to enable an entrant to achieve minimum viable scale; hence there is no new entrant. In less extreme cases, the competitor may enter, but only at a higher marginal cost that makes it a less effective constraint on *A*'s prices.

- Even if the contracts are of short duration or are terminable at will, switching to the entrant could be an irrational strategy for a distributor for a variety of reasons, including the new entrant's need for a broad network of distributors in order to satisfy customer needs[30] or to achieve economies of scale, and the difficulty the entrant

[26] *See id.* at 531–32, 554.

[27] In addition to economies of scale in production or distribution, economies of scale can be present on the demand side in the form of network effects. Network effects occur where products become more valuable as more people use them. *See* Carl Shapiro, *Exclusivity in Network Industries,* 7 GEO. MASON L. REV. 673 (1999); David A. Balto, *Networks and Exclusivity: Antitrust Analysis to Promote Network Competition,* 7 GEO. MASON L. REV. 523 (1999).

[28] *Cf.* Horizontal Merger Guidelines, *supra* note 9, § 2.22 (nonparty capacity constraints can make unilateral price increase profitable).

[29] *See* Riordan & Salop, *supra* note 24, at 555–56. This effect is similar in nature to the entry deterrence resulting from raising rivals' fixed, rather than marginal, costs. On such entry deterrence, see *id.* at 545 n.82.

[30] Customers may need wide distributor coverage to provide maintenance and repair, for example.

may have in developing brand recognition without widespread distribution.[31] Thus, there might be a collective action problem: it would be rational for a large number of distributors to switch, if only they could coordinate with each other, but it might be irrational for any one distributor to switch independently.

The exclusionary effects identified in the context of 99 percent or 100 percent exclusivity also can be seen in cases involving lower percentages of exclusivity. The same analysis will apply, with appropriate adaptations to the facts. For example, a contract requiring 70 percent exclusivity could harm competition if:

- at *A*'s profit-maximizing price, a competitor cannot achieve minimum viable scale by serving 30 percent of the market, or by paying a premium for less efficient distribution;
- *A*'s competitors have higher marginal costs than *A* itself, because either sponsoring alternative distributors or serving only 30 percent of the market is more expensive;
- a 30 percent "capacity constraint" allows *A* to raise prices; or
- the vertical contracts reduce the expected return on investments by *A*'s competitors in quality improvements or other dimensions of competition.

For any given market, the likelihood of anticompetitive effects probably falls rapidly as the percentage of exclusivity falls, but there is no magic number below which anticompetitive effects are impossible without regard to the market circumstances. In some markets, products will need to have nearly ubiquitous distribution in order to succeed, and a relatively small foreclosure could have a very large impact. Smaller requirements for distribution will lead to higher thresholds for anticompetitive foreclosure to be found. Thus, in accepting the *Time Warner* consent decree, the Commission took into account the fact that successful launch of a significant new cable programming channel usually requires distribution covering 40 percent to 60 percent of subscribers.[32]

It should also be noted that an exclusive dealing contract of even short duration or that is terminable at will can have anticompetitive

[31] This may be so, for example, if the goods in question are typically purchased on impulse, so that widespread distribution is necessary in order to achieve minimum viable scale.

[32] Time Warner, Inc., 123 F.T.C. 171, 211 (1997) (consent order).

effects.[33] Consider the following hypotheticals (which should be considered examples rather than an exhaustive list):

- Manufacturer *A* has 100 percent exclusive dealing contracts with 80 percent of the retailers in a market. No retailer is willing to switch to manufacturer *B* because *B* lacks brand recognition. Manufacturer *B* is willing to launch a substantial media campaign to build brand recognition. But if it does so, and consumers who visit their retailers do not find product *B* on the shelves, the money will be wasted. Still worse, consumers will be irritated if they look for the brand and cannot find it, and thus the advertising will generate ill will rather than good will. Only if Manufacturer *B* can get at least some minimal carriage—perhaps 5 percent of the shelf space devoted to the product category, in at least 50 percent of the retailers in the market—can it sustain the proposed media campaign. *A*'s exclusive contracts prevent *B* from reaching this necessary minimum of exposure, regardless of the duration of those contracts.

- Manufacturer *C* has exclusive dealing contracts with all twenty distributors of a product in the country. Distribution is highly localized, as transporting the product is expensive. Barriers to entry into distribution are high. If entrant *D* could get carriage by seven of the distributors, it could sell enough product to reach minimum viable scale at current prices. If it fails to get all seven, it will go out of business. If it goes out of business, any distributor that chose to abandon *C* in order to carry *D*'s products will be injured because *C* has made clear it will not resume sales to a distributor making this choice. It may well be difficult for the distributors to coordinate among themselves to support *D*, or for *D* to orchestrate such coordination, because of the high stakes and the substantial element of uncertainty. And even if, despite all the obstacles, each distributor is highly confident that *D* has secured distribution from seven distributors, there may be substantial uncertainty about whether seven will be enough.

- Distributors of product *E* not only sell the product but also provide essential service on it. Thus, customers are unwilling to buy the product unless the manufacturer has a broad distribution network. The incumbent manufacturer has exclusive dealing contracts with distributors, and the contracts are terminable at will. When a would-

[33] *Cf.* PepsiCo, Inc. v. Coca-Cola Co., 1998-2 Trade Cas. (CCH) ¶ 72,257, at 82,644–45 (S.D.N.Y. 1998) (while there are cases holding that exclusive dealing arrangements of short duration or terminable at will are not unlawful because competitors could "compete for the contract," extraction of even a short-term agreement not to deal with any competitor

be entrant tries to enlist distributors, distributors see that the entrant has no customers so they decline to switch. When the entrant tries to promote the products to customers, customers see that it has no distributors, so they too decline to switch. Thus, the potential entry does not occur.

- Because of permitting requirements, barriers to re-entry into product *F* are high once a firm exits the business. Minimum viable scale requires a 20 percent market share. Firm *G* secures exclusive dealing arrangements with 85 percent of the final users of product *F*, who agree to buy 100 percent of their requirements from *G*. Firm *H*, which previously had 25 percent of the market, now finds that it cannot make enough sales to stay in business, and exits. Although the contracts are of short duration or terminable at will, the barriers to re-entry keep *H* from returning.[34]

Each of these exclusive dealing scenarios also has an analog in partial exclusive dealing arrangements. In the first hypothetical, a 96 percent exclusive dealing arrangement would clearly be equally effective. But a still lower percentage might also be effective if there are reasons why the percentage of shelf space not covered by the incumbent's contract is nonetheless unavailable to the entrant or is available only at prohibitive cost. In the second hypothetical, a partial exclusive dealing arrangement could make it almost as hard for entrant *D* to reach minimum viable scale as would a complete exclusive dealing arrangement; as in the latter case, the risk that not enough of the distributors will switch to the entrant would prevent most or all of them from doing so. In the third hypothetical, it might appear that the entrant can get full distributor coverage by signing up a large number of distributors for whatever small percentage of the distributor's sales is allowed to the entrant under the contract. But if the allowable percentage is so small that it is not worth

can be exclusionary and an act of monopolization or attempted monopolization, where the buyers cannot do without the seller's product or service).

[34] This could be, but is not necessarily, a predatory pricing hypothetical. End-users will only enter into such a contract with firm *G* if they are paid to do so by more favorable terms. These could be predatory terms, but need not be. One might wonder why the end-users would accept these terms if they can foresee that it will mean higher prices in the long run. One answer is that coordination problems among the end-users could make it attractive for each end-user to accept the exclusive terms to obtain the more favorable price, even though it will result in higher prices in the long run, because each user expects the others to accept the proposal in any event. *See* Rasmusen, *supra* note 15. Thus, where there are large or sophisticated buyers that could forgo short-term favorable pricing in order to preserve competition for the future, this scenario is less likely to be operative. On the other hand, if there is only a small number of large buyers, and other buyers cannot reposition, it may be possible for the seller to share rents with the large buyers and still find exclusive dealing profitable.

the distributor's effort to invest the resources needed to carry the entrant's line, it may not be possible to obtain such coverage. In the fourth hypothetical, Firm *G* can achieve the same result by securing arrangements with all of the final users of product *F* that they will buy 85 percent of their requirements from *G*.

B. DISCOUNTS AND INCENTIVES CAN PRODUCE DE FACTO EXCLUSIVITY

Total or partial exclusivity is not necessarily the product of explicit contractual requirements. Incentives can also be used to achieve this outcome. Consider a firm that is a dominant manufacturer of a differentiated product facing a single, much smaller competitor. Suppose this dominant firm is so well established among ultimate consumers that its customers (distributors or, in the case of an intermediate good, manufacturers of finished products) have a base, inelastic demand for the firm's products in 60 percent of their business. Now suppose the dominant firm charges a normal price to customers that take up to 69 percent of their requirements in its brand, and then offers a discount of 6 percent to those that take 70 percent or more of their requirements, with this discount going back to the first unit of purchase. On its face this looks like a discount that tops out at 6 percent.

Even this apparently modest "market share discount" could have a strong tendency to shift purchases because, for practical purposes, the entire dollar value of the discount will be concentrated on the decision whether to buy the incremental units between 60 and 70 percent of requirements. Viewed from the other side of the transaction, the buyer faces a tax or a "penalty" in the form of the loss of all cumulative discounts if it takes a unit from an alternative supplier beyond 30 percent of its needs.[35] A smaller competitor would find it hard to match these incentives and penalties because it would have to match the absolute dollar value of the discount on its own smaller sales volume, thereby necessitating a larger percentage discount.[36]

[35] *Cf.* Kenneth C. Baseman et al., *Microsoft Plays Hardball: The Use of Exclusionary Pricing and Technical Incompatibility to Maintain Monopoly Power in Markets for Operating System Software,* 40 ANTITRUST BULL. 265, 297 (1995).

[36] This feature of having to spread the same total discount over a smaller number of sales is also characteristic of lump-sum up-front payments, often referred to as "slotting allowances." In monopoly or oligopoly markets, up-front payments can effectively act as an "entrance fee" that raises the barriers to new entry into the market because they constitute substantial sunk costs. Such payments or allowances may have effects far different from those in more competitive markets, where they can benefit consumers by permitting makers of new and innovative products to assume or share the risks of introducing a new product by buying their way onto the shelves of retailers or distributors. *See generally Competitive Issues in Agriculture and the Food Marketing Industry: Hearings Before the House*

The following table shows in a more numerical way how these factors might operate. Assume that a dealer has a total demand of ten widgets, currently priced at a dealer list price of $115 per unit. Assume further that, because of consumer brand preferences, the dealer faces a fixed demand for Brand *A* widgets (not sensitive to relative prices between Brand *A* and other brands) for 60 percent of its requirements, and must purchase 70 percent of its requirements from Brand *A* to qualify for a discount of 6 percent. The 60 percent fixed demand for Brand *A* products may arise from the fact that some customers are located in areas where the competitor's service network is poorly developed, or it may result from other reputational factors.[37] Rather than viewing the discount as one of $7 off the initial price of $115 per unit for each of seven widgets, the buyer would more practically view it as a discount of $49 for just the incremental unit:

WIDGET PRICES

EFFECTIVE PRICES TO HYPOTHETICAL BUYER

TOTAL MARKET: 10 UNITS	**EFFECTIVE PRICE OF BRAND A WIDGETS** **Average and Marginal Cost: $100**
UNITS 1–6	$115
NOMINAL PRICE OF UNITS 1–7	$108 ($115 less 6%) (Total discount $49)
UNIT 7	$66 ($115 less $49)
UNITS 8–10	$108

Note that, in this example, the marginal price of $66 is below the marginal cost of $100, and the conduct could, therefore, be described as predatory under the usual sorts of cost-based tests, assuming that the

Committee on the Judiciary, 106th Cong. (1999) (statement of the Federal Trade Commission, presented by Willard K. Tom, Deputy Director, Bureau of Competition).

[37] In effect, Firm *A* is a monopolist as to the first six units. Only the seventh through tenth units are open to competition. It is as if the first six units were a different product than the remaining units. In that sense, the hypothetical is economically equivalent to the cases involving discounts for aggregate purchases of a bundle of products, as discussed *infra* text accompanying notes 69–75.

likelihood of recoupment could also be shown.[38] Alternatively, one could regard a pricing scheme designed so that a buyer's only way to minimize short-term prices is by purchasing all or a particular percentage of its requirements from one seller as equivalent to complete or partial exclusive dealing and—as we do here—apply exclusive dealing analysis to the conduct.[39]

The discussion so far has dealt with de facto exclusive dealing achieved by the structure of a generally applicable pricing policy. It may well be that a dominant firm could achieve de facto exclusive dealing even more easily through selective retaliation against "disloyal" dealers or by cutting off access to an important input altogether, rather than setting a different schedule of prices.[40]

If an anticompetitive effect is found, a rule of reason analysis would consider any efficiencies that might result from the practice. It sometimes is suggested that market-share discounts produce consumer benefits by allowing smaller customers to buy on more equal terms (i.e., that smaller customers can more easily qualify for market-share discounts than for volume discounts), by giving both parties greater security and predictability in the flow of orders, or by encouraging buyers to specialize in the manufacturer's product and thereby represent it more effectively. It is not clear, however, that such benefits necessarily would overcome an anticompetitive effect. The facts might not support the existence of the claimed efficiency, the claimed efficiency might not produce consumer benefits in the relevant market, the benefits might be attainable through less restrictive but equally practical means, or the efficiencies might simply be insufficient to overcome the anticompetitive effects. Contem-

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[38] Brooke Group Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209 (1993).

[39] In the first *Microsoft* case, the Justice Department expressed a similar concern about volume discounts being used to create exclusive dealing arrangements. The Department explained:

> While the Department recognizes that volume discount pricing can be and normally is pro-competitive, volume discounts can also be structured by a seller with monopoly power (such as Microsoft) in such a way that buyers, who must purchase some substantial quantity from the monopolist, effectively are coerced by the structure of the discount schedule (as opposed to the level of price) to buy all or substantially all of the supplies they need from the monopolist.

United States v. Microsoft, 59 Fed. Reg. 42,845, 42,854 (Aug. 19, 1994) (Proposed Final Judgment and Competitive Impact Statement). The Division did not, however, find evidence that Microsoft had structured its volume discounts to achieve those anticompetitive results. *See also* Minnesota Mining & Mfg. Co. v. Appleton Papers Inc., 35 F. Supp. 2d 1138, 1144 (D. Minn. 1999) (in denying summary judgment, court noted that inelastic base could make it harder for dealers to switch suppliers).

[40] *Cf.* Lorain Journal Co. v. United States, 342 U.S. 143 (1951) (newspaper monopolized when it refused to deal with advertisers that advertised on competing radio stations).

poraneous intent evidence may be particularly useful in coming to grips with these issues as it will help determine what efficiencies actually were perceived as important to business managers at the time, a factor relevant to judging how much weight to assign to a particular efficiency. The specific circumstances of a market also may be a relevant factor; practices that may be necessary to elicit dealer promotional effort on behalf of a small manufacturer may bear little relation to consumer welfare when imposed by a monopolist.[41]

III. LEGAL ANALYSIS OF PARTIAL EXCLUSIVE DEALING AGREEMENTS AND INCENTIVES

In determining whether there is anything in the case law of exclusive dealing that would prevent antitrust principles from reaching partial exclusive dealing agreements, the central issue is whether particular vertical restrictions are harmful to competition and, if so, whether they are harmful to consumers in their net effects. We should not get caught up in linguistic arguments over whether a particular contract does or does not require literal "exclusivity."[42]

While the cases do not spell out black-letter law for dealing with situations that fall short of perfect exclusivity, three general legal observations can be made. First, the case law[43] does not forbid anticompetitive

[41] Distinguishing anticompetitive from procompetitive effects often may be more difficult in the case of incentive-based arrangements than in the case of contractual exclusivity. Adjusting prices in response to differing elasticities of demand of different customer populations can have efficiency characteristics. *See, e.g.*, F.M. SCHERER & DAVID ROSS, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE 494–500 (3d ed. 1990) (discussing Ramsey pricing). Consequently, where the marginal prices of some units fall below marginal cost, as discussed *supra* text accompanying note 38, that fact can help distinguish procompetitive from anticompetitive conduct. Internal strategic documents can also be powerful evidence from which to infer effect.

It should also be noted that incentive-based arrangements are almost by definition of short duration or terminable at will. For reasons discussed *supra* text accompanying notes 33–34, that does not necessarily preclude anticompetitive effects.

[42] The Supreme Court has long emphasized the importance of studying the underlying economic and business realities before reaching a conclusion about any particular arrangement: "Legal presumptions that rest on formalistic distinctions rather than actual market realities are generally disfavored in antitrust law. This Court has preferred to resolve antitrust claims on a case-by-case basis, focusing on the 'particular facts disclosed by the record.'" Eastman Kodak Co. v. Image Technical Servs., Inc., 504 U.S. 451, 466–67 (1992) (citing Maple Flooring Mfrs. Ass'n v. United States, 268 U.S. 563, 579 (1925)).

[43] The following discussion draws on cases decided under the Sherman Act, the FTC Act, and § 3 of the Clayton Act. These statutes differ somewhat among themselves, and only Clayton § 3 specifically addresses sales made on condition that the purchaser "shall not use or deal in the goods . . . of a competitor . . . of [the] seller." 15 U.S.C. § 14. The Sherman Act and the FTC Act are framed in more general terms of "unreasonable" restraints on competition, and "unfair" methods of competition. Thus, even if a few cases under the Clayton Act might be read as demanding "requirements" or "exclusivity" there,

exclusive dealing contracts only when they embody a binding "requirement" of exclusivity. Second, the case law does not forbid anticompetitive exclusive dealing contracts only when they embody an undertaking to deal 100 percent "exclusively." Third, incentive-producing price structures are not per se legal even if all parts of them are above cost.

A. An Absolute "Requirement" of Exclusivity Is Unnecessary

From a purely linguistic point of view, one might think that an exclusive dealing contract must be one in which the buyer has been made subject to some literal, binding "requirement" of exclusivity. This error comes from neither the statutes—apart, perhaps, from the Clayton Act—nor from the cases, but rather from the shorthand that courts and commentators have used to describe arrangements that restrict the buyer's ability to choose among sellers. When carefully reviewed, the case law recognizes that "mere incentives" to exclusive dealing can become sufficiently strong to result in actual requirements for all practical purposes.

Many cases over the years have construed particular incentives toward exclusive dealing or tying as imposing de facto obligations. In one case where the buyer risked forfeiting its leases if it used the products of a competing supplier, the Supreme Court noted that the contracts at issue "effectually prevent [the lessee] from acquiring the machinery of a competitor . . . except at the risk of forfeiting the right to use the machines . . . which may be absolutely essential to the prosecution and success of his business."[44] In those circumstances the Court found a violation: "This system of 'tying' restrictions is quite as effective as express covenants could be and practically compels the use of the machinery of the lessor except upon risks which manufacturers will not willingly incur."[45] In another case, lessees who used both the seller's and competing machines had to pay an additional royalty, which, although not quantified in the Court's opinion, was "onerous." The court legitimately concluded that "the obligation thereby imposed is absolute," resulting in a violation.[46] In a third case, buyers who carried competing products saw their discount off list price shrink from 40 or 50 percent to 25 percent. The Eighth Circuit found this pressure to be the equivalent of an overt requirement:

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e.g., Magnus Petroleum Co. v. Skelly Oil Co., 599 F.2d 196 (7th Cir. 1979), one cannot read those cases as imposing a broad limitation on proceeding under the more general language in the other acts. See Balto, *supra* note 27, at 561–71, for a more detailed discussion of the law.

[44] United Shoe Mach. Corp. v. United States, 258 U.S. 451, 458 (1922).

[45] *Id.*

[46] Chiplets, Inc. v. June Dairy Prods. Co., 89 F. Supp. 814, 817 (D.N.J. 1950).

> Under these circumstances it is immaterial that those who handled [the seller's] products were not obliged to affirmatively promise in express terms not to handle goods of [its] competitors. The condition against handling the goods of competitors was made as fully effective as though it had been written in and affirmatively agreed to in express terms in the contracts.[47]

Naturally, not every incentive provision or conditional penalty will amount to a de facto exclusive dealing contract. Some variation in contract terms may be intended for different purposes, may be so small in its effects that it cannot realistically be described as a "requirement," or may be something that a competitor could have matched without incurring a significant cost penalty. Several cases have found no violations in these types of situations. In *Barry Wright*, for example, the court concluded that a contract offering special discounts of 5 to 10 percent in exchange for substantially all of the buyer's business was not likely to have "significantly interfered" with the buyer's ability to seek new sources of supply if desired.[48] In another case the court declined to find a violation resulting from a seller's practice of offering promotional gifts that represented an unstated, but presumably small, percentage discount.[49] Needless to say, the circumstances of most concern to the antitrust counselor or enforcer will be those in which the incentives toward particular conduct actually bring about that conduct. It is in these cases, rather than the instances of minor promotional gifts, that demonstrable anticompetitive intent and causation are most likely to be present.[50]

B. Absolute "Exclusivity" Is Unnecessary

A literal approach to the "exclusive dealing" part of the exclusive dealing contract might suggest that "exclusivity" demands that a contract

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[47] Carter Carburetor Corp. v. FTC, 112 F.2d 722, 732 (8th Cir. 1940).

[48] Barry Wright Corp. v. ITT Grinnell Corp., 724 F.2d 227, 238 (1st Cir. 1983); *see also* Western Parcel Express v. United Parcel Serv. of Am., Inc., 190 F.3d 974 (9th Cir. 1999). In the latter case the court held that UPS's pricing schedule represented volume discounts rather than tacit exclusive dealing requirements. While some of the court's language might appear to say that a volume discount could not be a disguised requirement of exclusivity, the better reading seems to be that the court was aware of other factors in that particular market, such as low entry barriers, that would keep any exclusivity requirement from being harmful.

[49] *See* Stitt Spark Plug Co. v. Champion Spark Plug Co., 840 F.2d 1253 (5th Cir. 1988). The court noted that there was little evidence of actual effect on distributors' purchases.

[50] In addressing causation issues, however, some courts have found that a nominally small discount actually translates into a much larger discount in particular factual contexts. *See, e.g.*, SmithKline Corp. v. Eli Lilly & Co., 575 F.2d 1056, 1062 (3d Cir. 1978) ("Although the [defendant's price structure] only gave a 3% bonus rebate, because of Lilly's volume advantage, in order to offer a rebate of the same net dollar amount as Lilly's, SmithKline had to offer purchasers of [its drug] rebates of some 16% to hospitals of average size, and 35% to larger volume hospitals.").

be 100 percent exclusive. This, too, is an unduly rigid view of the law. Even contracts with partial exclusivity cause anticompetitive effects under certain factual conditions, and in those circumstances such contracts properly can be condemned under the antitrust laws.

At first glance it might appear there is case law supporting the literalist position. Some cases suggest that agreements must require a very high level of exclusivity, perhaps even 100 percent, before they can be considered "exclusive dealing contracts." One court refused to find a requirement of exclusivity when the buyer had to purchase from the seller a stated quantity somewhat less than 60 to 80 percent of its needs. The court concluded this requirement did not amount to true "exclusivity"; the court further found that the agreement did not threaten competition because it did not foreclose a competitively significant share of the market.[51] Another court apparently concluded that only a near-total commitment would constitute exclusive dealing, noting that a true requirements contract "flatly eliminates the buyer from the market" in a way not accomplished by a contract for a stated dollar amount of purchases equal to the buyer's entire estimated requirements.[52]

These cases probably are not as broad as they first seem, however. While courts have sometimes required a high degree of exclusivity with one supplier before they will subject a contract to close examination, most exclusive dealing cases are brought against a background in which many other suppliers and many other purchasers of the product are present in a market. In those circumstances, even total exclusivity between any one pair of partners is unlikely to do much harm and, in fact, may permit some efficiencies.[53] Consequently, in the usual case there is no need for the court to consider whether something less than 100 percent might amount to de facto exclusivity.

Nevertheless, as shown above, a supply or distribution contract that does not impose absolute exclusivity still can cause anticompetitive effects. This will occur when the contract deprives rivals of economies

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[51] *See* Magnus Petroleum Co. v. Skelly Oil Co., 599 F.2d 196 (7th Cir. 1979).

[52] *See* Barry Wright Corp. v. ITT Grinnell Corp., 724 F.2d 227, 237 (1st Cir. 1983) (case under Sherman Act §§ 1 & 2). The court reasoned that the buyer's eventual needs might be greater than the original estimate, in which case it could purchase the excess from any supplier it chose. *Id.* This freedom might be important insofar as it allowed a buyer to start with a small order in one year and expand purchases in later years. *Id.*

[53] *See, e.g.,* Jefferson Parish Hosp. Dist. No. 2 v. Hyde, 466 U.S. 2, 45 (1984) (O'Connor, J., concurring) (exclusive dealing "is an unreasonable restraint on trade only when a significant fraction of buyers or sellers are frozen out of a market by the exclusive deal"). A number of court decisions permitting exclusive dealing contracts can be distinguished as involving insignificant shares of the market. *See, e.g.,* Roland Mach. Co. v. Dresser Indus., Inc., 749 F.2d 380, 394 (7th Cir. 1984) (Posner, J.) ("exclusion of competitors is cause

of scale or otherwise raises their costs or deters investments in other dimensions of competition. Such effects are most likely where the seller is not merely one supplier among many, but rather is dominant and has locked up a large fraction of the available outlets or inputs.[54] If competition actually is lessened in this way, the courts are likely to condemn the contract as anticompetitive, regardless of whether it calls for partial or for total exclusivity. This is the conclusion reached in *Concord Boat Corp. v. Brunswick Corp.*[55] and in *R.J. Reynolds Tobacco Co. v. Philip Morris, Inc.*,[56] which are among the few cases to have considered situations involving these types of allegations.

In *Concord Boat* a class of boatbuilders sued the maker of MerCruiser brand sterndrive boat engines, claiming that the market-share discounts on the engines gave buyers an incentive to take so large a part of their requirements in Mercury engines that the sole competing manufacturer, Volvo, was held to a size below minimum efficient scale. They further argued that industry prices were increased as a result.[57] The trial judge upheld a jury verdict for the plaintiffs. In *R.J. Reynolds* a district court granted a preliminary injunction against a promotional program of the dominant cigarette manufacturer—Philip Morris—which gave discounts to retailers that set aside a large percentage of their display space for Philip Morris products. The court found this program affected such a high percentage of shelf space at such a high percentage of retailers that it threatened the viability of firms by preventing exposure in a market where many ordinary forms of advertising were barred. This, in turn, threatened to harm interbrand competition and consumer choice.[58] Thus, incentives to partial exclusive dealing, when engaged in by a dominant firm, can be anticompetitive.

Although there are some cases that might appear inconsistent with this analysis, they seem to be distinguishable on their own facts and do not seem to set out any general principle of law contrary to that suggested. Now-Justice Breyer's opinion in *Barry Wright* seems best interpreted as one of these special circumstance cases. The case involved a contract for

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for antitrust concern only if it impairs the health of the competitive process itself"); Beltone Elec. Corp., 100 F.T.C. 68, 204 (1982).

[54] Compare this situation with *U.S. Healthcare, Inc. v. Healthsource, Inc.*, 986 F.2d 589, 596 (1st Cir. 1993), where the court rejected the plaintiff's claims and observed that potential competitors could still obtain sufficient inputs.

[55] 21 F. Supp. 2d 923 (E.D. Ark. 1998), *appeal docketed*, No. 98-3732 (8th Cir.).

[56] 60 F. Supp. 2d 502 (M.D.N.C. 1999) (granting a preliminary injunction).

[57] 21 F. Supp. 2d at 932.

[58] *See* 60 F. Supp. 2d at 511.

the supply of "mechanical snubbers"—devices used in the construction of nuclear power plants. The manufacturer gave a special discount of 5 to 10 percent to a large customer that agreed to buy a stated dollar amount of product, equal to its entire estimated requirements for the next two years. The loss of this account was so important to the sole competing manufacturer that it went out of the snubber business entirely. The First Circuit nonetheless found that the contract in that case was permissible.[59] In doing so, however, the court did not articulate a general rule that such contracts are legal as long as they are not framed explicitly in terms of 100 percent exclusivity. Rather, the court seems to have been responding to a number of circumstances, unique to the market under consideration, suggesting that competition had not been threatened. First, the dominant firm had substantial excess capacity and costs that continued to decrease with volume, indicating this market may have had room for only one efficient-sized firm.[60] Second, the contract was for a limited period of time, leaving other firms the chance to compete for sales in future periods.[61] Third, there was evidence that the excluded firm had missed delivery schedules under earlier contracts and proved to be an unreliable supplier.[62] Fourth, the allegedly "victimized" buyer actually was far larger than its suppliers and easily could encourage new upstream entry if it believed snubbers were no longer available on competitive terms.[63] Thus, antitrust is a very fact-specific enterprise, and the existence of some cases upholding the legality of partial exclusive dealing arrangements should not lead to a departure from the general rule of reason principle requiring the court to focus on the harms and benefits of the particular challenged practice in the specific market circumstances in which it occurs. Substantially exclusive distribution

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[59] *See* 724 F.2d at 238.

[60] *Id.* at 237. In general, courts have an easier time condemning conduct that would not be rational but for the hoped-for anticompetitive effect. *Cf.* E.I. du Pont de Nemours & Co. v. FTC (*Ethyl*), 729 F.2d 128, 139–40 (2d Cir. 1984). Where a firm's marginal cost continues to decline with increased sales, it is easy to interpret various discounts as legitimate efforts to increase sales and thereby reduce costs. Where a firm forgoes short-term profits in order to raise rivals' costs, however, the conduct is more likely to be viewed as anticompetitive.

[61] *See* 724 F.2d at 237. As we have seen above, it is a mistake to assume that simply because one model of harm—too few contracts coming open in any one period for an entrant to achieve minimum viable scale—requires long-term contracts, that no harm can come in the absence of long-term contracts. But the absence of long-term contracts certainly is a factor in favor of lawfulness, insofar as it eliminates one possible theory of harm.

[62] While the evidence of unreliability does not seem to have been disputed, the court stated that it was not relying on this point. *See id.* at 229, 230.

[63] *Id.* at 237–38.

agreements can be unlawful, even where they do not require 100 percent exclusivity, if they are shown to be unreasonably exclusionary in their effects.

C. PRICES ABOVE COST ARE NOT ALWAYS LEGAL

A final observation is that complex pricing structures, designed to create incentives toward exclusive dealing, are not per se legal merely because each element in the structure is above the seller's cost. The relevant issue is the structure and effects of the price scheme.

As discussed above, if the financial benefits of a market-share discount are effectively concentrated on the decision whether to buy a relatively small number of marginal units, even prices that technically are "above cost" on average effectively may be below cost as to those marginal units. In that situation the pricing structure is likely to exclude rivals from that portion of the demand curve or to raise the rivals' costs. When the other requirements for an antitrust action are present, such as insufficient offsetting efficiencies and a harm to consumers, the conduct should be subject to antitrust scrutiny.

Again, some cases seem to say that above-cost pricing is necessarily legal. For example, the *Barry Wright* court noted that "the Sherman Act does not make unlawful prices that exceed both incremental and average costs."[64] Similarly, the court in *Henry v. Chloride, Inc.* did note that "at some point, competitors should know for certain they are pricing legally, and . . . this point should be average total cost. In other words, prices above average total cost are legal *per se.*"[65] These cases, however, are both readily distinguished on their facts. The courts made their respective statements in the context of relatively simple, straightforward predatory pricing claims. The courts essentially were noting—no doubt correctly—the need to be careful in assessing predation charges so as not to unduly chill the process of hard but legitimate price competition, which is beneficial to consumers.[66] The courts, for good reasons, viewed the specific above-cost predation theories presented in those cases with skepticism: costs were difficult to measure, and motive and purpose would be

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[64] *Id.* at 236.

[65] 809 F.2d 1334, 1346 (8th Cir. 1987).

[66] *See Barry Wright,* 724 F.2d at 235–36 (challenge to above-cost price cuts "threatens to 'chill' highly desirable pro-competitive price cutting"); *Henry,* 809 F.2d at 1344 ("non-predatory price cuts are to be encouraged under the antitrust laws"). The Supreme Court later expressed similar caution on predatory pricing claims. *See* Brooke Group v. Brown & Williamson Tobacco Corp., 509 U.S. 209 (1993) (illegal predation requires prices below a measure of rival's costs, and opportunity for recoupment).

difficult to assess in contexts like disciplinary pricing or limit pricing.[67] For these reasons the courts concluded that they should be slow to condemn a simple, uniform price as being "too low," if that is all that could be said against the price.

Incentives to exclusive dealing involve such a different form of pricing that these precedents are not applicable. The concern in exclusive dealing situations is not that prices are predatory or, if not predatory, that their general level is low enough to cause a competitive problem. Rather, the concern is that the particular *structure* of the prices is designed in such a manner that it amounts to a de facto exclusivity requirement.[68] This is an inquiry very different from predation, and it calls for different data.

Indeed, antitrust law already has found in other contexts that the structure of a manufacturer's prices can be improperly exclusionary, even if each individual element in the structure is above the relevant measure of costs. This is the teaching of the cases that have considered "package" or bundled pricing. Cases where packaged or bundled pricing structures have been challenged involve situations in which a manufacturer sells a group of related products; on some of the products the seller possesses market power, and on others it does not. If the manufacturer offers a discount on a "bundle" of these products when purchased together, it may be able to force out of business a more efficient manufacturer of a single product.[69] This effect may occur as a result of the structure of the manufacturer's pricing, and it may not depend on any single price being below cost or on the economic benefits of the bundled purchase being so great that the matter must be assessed as a tying case. Two of these cases are particularly notable, *Ortho Diagnostics* and *SmithKline.*[70]

Ortho Diagnostics involved a series of five medical tests used in screening blood supplies for the presence of viruses. The defendant, Abbott Laboratories, possessed market power over at least two of these tests and offered

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[67] *See Barry Wright,* 724 F.2d at 235.

[68] Price structures have been found anticompetitive in at least one case involving incentives to exclusive dealing. *See* Concord Boat Corp. v. Brunswick Corp., 21 F. Supp. 2d 923 (E.D. Ark. 1998), *appeal docketed,* No. 98-3732 (8th Cir.).

[69] For a quantified example of how this might come about, see Ortho Diagnostic Sys., Inc. v. Abbott Labs., Inc., 920 F. Supp. 455, 467 (S.D.N.Y. 1996).

[70] *Id.*; SmithKline Corp. v. Eli Lilly & Co., 427 F. Supp. 1089 (E.D. Pa. 1976), *aff'd,* 575 F.2d 1056 (3d Cir. 1978). A third case is still being litigated, but the court has held that allegations of multi-product bundling resulting in de facto exclusive dealing can make out a valid cause of action. *See* Lepage's Inc. v. Minnesota Mining & Mfg. Co., 1999-1 Trade Cas. ¶ 72,538 (E.D. Pa. 1999) (denying motion for summary judgment). Following a jury verdict for the plaintiff, a motion for judgment notwithstanding the verdict is being briefed as of this writing.

a discounted price to blood banks that purchased all five. Abbott defended this practice on the grounds that above-cost discounts were, as a matter of law, "legitimate and desirable."[71] Because the rule relied upon by Abbott had emerged in the context of predation cases, and predation cases involve a price on a single product, the predation case law "differ[ed] in a vital respect" from a case involving bundling.[72] The "salient feature[]" of Abbott's challenged practice was instead the "pricing structure."[73] The court thus found that the plaintiff had a valid cause of action. "[T]he fact that the components of Abbott's package all are priced at or above average variable cost is not alone fatal to Ortho's Section 2 claims."[74]

The *SmithKline* litigation involved similar bundling of different cephalosporin antibiotics. The defendant faced no competition in two of its products, and offered a 3 percent rebate to purchasers who bought any three cephalosporin products from it. The court held that this practice violated Section 2 because it tended to stifle competition in the cephalosporin market generally.[75] En route to this conclusion the court rejected an above-cost defense: "[A] monopolist does not receive immunity merely because it has priced the product in issue above its average cost."[76]

The principle established in the bundling cases applies to sales of a single product as well. Where the pricing structure, rather than the price level, is used to secure an anticompetitive result, the cost test of predatory pricing does not automatically apply. Instead, one must conduct a case-by-case analysis of the actual effects of the particular practice to determine whether anticompetitive outcomes are likely.

V. CONCLUSION

The approach outlined above is essentially conservative. It would keep the law of vertical restraints focused where it is now—on the actual competitive effects of challenged practices. It would avoid technical, linguistic quibbles, such as whether arrangements are precisely "requirements" or are precisely "exclusive." It would let counselors and enforcers

[71] 920 F. Supp. at 463.

[72] *Id.* at 466.

[73] *Id.* at 460; *see also Lepage's,* 1999-1 Trade Cas. ¶ 72,538, at 84,849 (distinguishing the Supreme Court's *Brooke Group* decision on this basis).

[74] 920 F. Supp. at 468. The court went on to find that the particular pricing structure used by Abbott was not so exclusionary as to "mak[e] it unprofitable for the plaintiff to continue to produce," and that the principal monopolization count should be dismissed on that basis. *Id.* at 469.

[75] *See* 427 F. Supp. at 1121.

[76] *Id.* at 1128.

concentrate instead on the core questions that have long been central to antitrust—whether the restraints at issue tend to create or facilitate horizontal problems of collusion or exclusion. The analysis thus remains where it should be, focused on effect rather than on formalistic line drawing.