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## ANTITRUST LAW AND COMPETITION FOR DISTRIBUTION

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# Antitrust Law and Competition for Distribution

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*The regulation of the competitive process for product distribution and promotion is an unsettled and incoherent area of antitrust law. Competition for distribution involves contracting activity regarding the decision to carry, promote, or place a particular product. This process includes business practices recently subject to intense antitrust scrutiny such as slotting allowances, discounts, bundled rebates, category management, and exclusive dealing. Antitrust law has designed rules for each of these practices independently, ignoring the economic relationships between these business practices. Focusing on the economics of the competitive process for distribution exposes an antitrust policy that systematically mishandles the regulation of these contracts. These economic insights suggest that per se legality for arrangements less than one year in duration or arrangements that foreclose less than 40% of total distribution would improve consumer welfare without significant risk of anticompetitive harm.*



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## Introduction

The regulation of the competitive process for product distribution and promotion is an unsettled and sometimes incoherent area of antitrust law. One potential explanation for the lack of coherence and consistency in this area is the expansive nature of the subject matter. Marketing and distribution practices encompass a large and diverse set of contractual relationships between manufacturers and retailers.[1] The search for a single legal standard sufficient to gauge the competitive impact of this diverse set of practices may be the cause of much of the confusion. A second explanation is that problems in the antitrust law governing distribution relationships are caused by a fundamental misunderstanding of the economics of these distribution relationships. This paper explores the second explanation.

The scope of this Article is the regulation of *competition for distribution*, which I define as manufacturer and retailer contracting activity regarding the decision to carry, promote, or place a particular product. By this definition, competition for distribution includes manufacturer payments to retailers for shelf space in the forms of wholesale price discounts, slotting allowances, and bundled rebates, coupled with exclusionary terms and category management designed to prevent retailer "cheating." Recent antitrust litigation demonstrates that competition for distribution has perplexed courts and antitrust agencies. I define these practices more precisely in order to clarify the manufacturer and retailer activities at issue.

Slotting allowances involve per-unit time payments for shelf space. Though the term "slotting allowance" usually refers to the supermarket industry, payments for premium distribution "space" occur in other retail markets such as bookstores, department stores, and drug stores. Analogous payments for promotional display also occur in other markets, such as payments for space in a mutual fund supermarket or for radio airplay. The distinguishing feature of slotting allowances is that manufacturers pay them up-front for shelf time per unit, rather than for each unit that the retailer sells.

1 I will refer to retailers as "dealers" and "distributors," while sellers are sometimes referred to as "manufacturers."

These variable payments can be thought of as a reduction in the manufacturer's wholesale price. Both slotting allowances and wholesale price discounts belong to the category of manufacturer expenditures for promotion and distribution often labeled "trade promotions."[2]

Bundled rebates are another form of manufacturer payment to retailers for distribution. The distinguishing characteristic of a bundled rebate is that the manufacturer offers the retailer discounts that increase when the retailer also purchases the manufacturer's products in other markets. For example, a manufacturer might offer a retailer a 10% discount if it purchases product *A*, a 20% discount if the retailer purchases products *A* and *B*, and a 30% discount if it purchases the manufacturer's full product line of *A*, *B*, and *C*.

A category management arrangement involves the retailer granting rights to control offerings in a particular product category to a supplier known as the "category captain." Though such arrangements vary across categories, category captains generally analyze data from category sales, suggest shelf space allocations, and work with the retailer to maximize category profits.

The primary contribution of this Article is to focus on the economic forces underlying the competitive process for distribution, exposing significant and frequently ignored relationships *among* these practices. This analysis suggests modern antitrust policy systematically mishandles the regulation of distribution contracts. This Article proposes improvements to this area of the law consistent with the economic insights provided.

Part I of the paper summarizes the economics of competition for distribution, relying heavily on a growing economics literature analyzing manufacturer payments for distributor promotion and exclusive dealing. This economic framework provides the basis for the legal analysis that follows. Part II reviews the modern antitrust approach to distribution arrangements, highlighting the recent struggles many courts have had in assessing the likely competitive consequences of competition for distribution. Part III builds upon the economic insights of Part I, arguing that per se legality is appropriate for distribution contracts shorter than one year in duration as well as those that foreclose rivals from less than 40% of distribution opportunities.

## I. The Economics of Competition for Distribution

Competition for distribution is a crucial part of the competitive process in a number of industries. Grocery manufacturers compete for valuable shelf space, record labels compete for radio airplay, and firms of all sorts compete for the attention of consumers across virtually all product markets. In these

2 Other forms of trade promotions involve the use of cooperative advertising reimbursement, cash rebates, coupons, consignment programs, display allowances, off-invoice allowances, bill-back allowances, or free goods. PHILIP KOTLER, MARKETING MANAGEMENT 489-90 (11th ed. 2003).

markets, we frequently observe manufacturers, rather than their dealers, making promotional investments. The fundamental economic question is why?

Economists have explained that it is often more efficient for manufacturers to make these investments by giving promotional assets to retailers at zero price, subsidizing their purchases, or paying the dealer for promotional performance. The economic reason that *manufacturers* must purchase promotional services is that, under a rather broad set of conditions, manufacturers will desire a greater level of promotion than dealers would otherwise supply.[3] This difference in incentives between manufacturers and retailers with respect to the supply of promotional activity implies that joint profit-maximization requires a separate distribution arrangement to compensate the dealer for supply of the desired level of services. In other words, the retailer, in the absence of such an arrangement, will not supply the jointly profit-maximizing level of promotion. The following Section outlines the economics of the dealer undersupply problem, and shows how manufacturers and retailers use a variety of contractual forms to solve it.

### A. *Promotional Contracts Solve a Pervasive Incentive Incompatibility Problem*

Dealers will not supply or purchase sufficient promotion from the manufacturer's point of view because they do not account for the additional profit earned by the manufacturer on incremental sales from optimal promotion decisions. Consequently, dealers may not supply the jointly optimal level of promotional effort, even though the revenue earned on those sales is greater than the costs of providing the services. Accordingly, manufacturers must either pay for distribution or lose profitable incremental sales.

The incentive incompatibility between manufacturers and retailers with regard to retail promotion can be illustrated mathematically.[4] As a comparative benchmark, consider the retailer's incentives with respect to price competition. Assume that the retailer's marginal cost of selling an additional unit of a product to consumers, $MC_R$, is equal to the wholesale price charged by the manufacturer, $P_W$, plus the retailer's marginal cost of selling the product, $MC_s$, which includes the retailer's costs of providing shelf space. The joint profit maximizing condition with respect to price competition is:

3 The original statement of the dealer undersupply problem, and the role of various vertical restraints in solving it, appears in Benjamin Klein & Kevin M. Murphy, *Vertical Restraints as Contract Enforcement Mechanisms*, 31 J.L. & ECON. 265 (1988). This analysis is extended in Ralph Winter, *Vertical Control and Price Versus Nonprice Competition*, 108 Q.J. ECON. 61 (1993) and further extended in Benjamin Klein & Joshua Wright, The Economics of Slotting Contracts (August 10, 2005) (unpublished manuscript, on file with author), where a model of slotting allowances as a particular form of manufacturer compensation for shelf space is presented and tested against available slotting data.

4 Klein & Wright, *supra* note 3, at 8-16, presents this analysis.

Desktop Publishing Example

(1) $$\frac{dQ_R}{dP_R}(P_R - MC_R) = \frac{dQ_M}{dP_W}(P_W - MC_M)$$

Notice that even when the manufacturer's margin is substantially larger than the retailer's margin, in equilibrium $dQ_R / dP_R$ will be proportionately greater than $dQ_M / dP_W$ because a retail price decrease causes shifts in sales between retailers (*inter-retailer effects*) that largely cancel out in terms of the manufacturer's net sales increase, or *inter-brand* effects. Although retailers do not take account of the manufacturer's much larger margin on incremental sales when lowering price, competition results in the jointly profit-maximizing level of retailer price competition because the manufacturer and retailers each adjust their prices so that their respective margins completely and exactly offset the increased retailer demand response with the higher manufacturer margin. Therefore, manufacturer and retail pricing incentives are generally aligned sufficiently such that a contract controlling the retailer's pricing conduct is not required in order to maximize joint profits.

Klein and Murphy demonstrate that this offsetting effect does not occur with many forms of promotion which do not involve significant inter-retailer demand effects.[5] This competitive distortion increases with the magnitude of the manufacturer's margin: the difference between the wholesale price and the manufacturer's marginal cost. Most differentiated products, for example, face downward sloping demand curves and are sold significantly above marginal cost.[6] Under these general conditions, manufacturers earn significant marginal profit from incremental sales and have strong incentives to induce retailer promotional efforts by compensating dealers for supplying additional promotional services.[7] If we denote these forms of promotion, such as shelf space, *S*, we can then assume that:

(2) $$\frac{dQ_R}{dS} = \frac{dQ_M}{dS}$$

Without substantial inter-retailer effects offsetting the manufacturer's larger margin on incremental sales, we know that the retailer's profitability from the incremental sales produced by its increased supply of *S* will be much smaller than the manufacturer's return. Mathematically, Equation (3) represents this deviation from the jointly profit-maximizing equilibrium:

5 *See id.* (examining the retailer undersupply problem in the context of vertical restraints such as exclusive territories or resale price maintenance which facilitate manufacturer payments to retailers for supplying desired services).

6 *Cf.* Benjamin Klein & John Shepard Wiley Jr., *Competitive Price Discrimination as an Antitrust Justification for Intellectual Property Refusals to Deal*, 70 ANTITRUST L.J. 599 (2003) (noting that virtually all firms produce differentiated, unique products and that such firms thus do not necessarily possess any antitrust market power).

7 Where all consumers equally value a particular retailer service, such as a well-lit store or parking, the retailer is compensated for the investment by an increase in the retail price equal to the value of the service supplied rather than by manufacturer payments.

(3) $$\frac{dQ_R}{dS}(P_R - MC_R) < \frac{dQ_M}{dS}(P_M - MC_M)$$

These conditions imply that profit-maximizing retailers will set *S* too low. Notice that the conditions necessary for Equation (3) to hold are not very restrictive: (1) heterogeneity in consumers' valuation of *S*; (2) a large manufacturer's margin relative to the retailer's margin; and (3) substantial inter-retailer effects of the provision of *S*. Under these conditions, the manufacturer will want the retailer to provide more promotional shelf space for its products than the retailer otherwise would. Because joint profits will increase if the manufacturer can increase retail promotion levels, an economic incentive exists for manufacturers to contract with retailers over the supply of shelf space.[8]

Promotion exists to induce purchases from marginal consumers, or those consumers who would not have purchased the product at current market prices. Promotional effort pushes the reservation values of marginal consumers towards or above the market price, while infra-marginal consumers' reservation values are unaffected, or not increased to the market price, because they do not respond to the promotion offered, such as valuable shelf space.

Consider the following numerical example to illustrate the competitive distortion. Manufacturer *X* sells a brand name stereo. The wholesale price of *X*'s stereo to retailers is $150, and the competitive retail price is $200. Infra-marginal consumers are purchasing the product at $200 and receiving consumer surplus. A marginal consumer values *X*'s stereo at $150, and therefore does not purchase the product. Providing *X*'s stereo premium shelf space would cost the retailer $100 and increase its value to the marginal consumer by $50. However, the retailer would not voluntarily supply the premium space. The incremental sale earns the retailer $50, which does not cover the $100 promotional expenditure. If the manufacturer's marginal cost is less than $50, however, the manufacturer will purchase the promotion because the manufacturer's incremental profit on the additional sale is greater than the total cost of supplying premium shelf space.

The economic incentive to specify a separate contract for retail distribution has significant implications for antitrust governance. This competitive distortion not only provides a pro-competitive rationale for a set of highly scrutinized practices, but it also permits an antitrust policy informed by an improved economic understanding of distribution relationships.

While this incentive incompatibility shows the need for a separate contract governing retailer supply of promotional activity, it does not determine the form that the contract should take. Generally speaking, it is useful to think of

8 Where inter-retailer demand effects exist from the provision of a particular promotional service, the retailer will provide these services without manufacturer compensation because it will adjust its retail prices to reflect the increased consumer demand.

manufacturers as seeking promotional effort that will increase total sales by a specified percentage. Manufacturers can resort to a variety of contractual forms to compensate retailers for this additional promotional activity. For example, the manufacturer might lower the wholesale price by a certain amount and engage in de facto resale price maintenance, offer cooperative advertising dollars to be rescinded if the dealer prices below a specified price, pay the retailer a per-unit time slotting allowance, use quantity-based rebates, or give the retailer other valuable consideration for its increased promotional effort.

While the particular form of the promotional contract is not the focus of this Article, it is an interesting and important economic question.[9] One aspect of this form question is relevant to the analysis herein. Specifically, a key determinant of the contractual form is the degree of inter-retailer competition in the particular product market, or the individual retailer price elasticity of the product.

Where intense inter-retailer competition exists for a particular product—that is, where a price increase induces significant store switching among consumers—competition will likely decrease the retailer's premium. The payment to the retailer will be competed away in the form of lower prices. The dissipation of this premium reduces the retailer's incentive to supply the bargained-for promotion. Thus, in the case of high inter-retailer competition, one might expect increased incidence of resale price maintenance or per-unit time payments to address this problem. Resale price maintenance prevents the retailer from reducing the price below a certain level. Similarly, a per-unit time payment such as a slotting allowance is less likely to be dissipated by price competition on the particular product. One can think of slotting payments as having the advantage over quantity-based discounts in that the former allow greater flexibility in selecting the margin upon which manufacturers pass the payment on to consumers. Therefore, this model predicts that resale price maintenance and slotting allowances are more likely to be observed where inter-retailer competition is particularly intense and that discounts are sufficient to compensate the retailer when inter-retailer competition is minimal.

### B. *Transactors Use a Variety of Contractual Mechanisms to Reduce Retailer Incentives to Cheat on Promotional Contracts*

Promotion contracts create a large and diverse set of free-riding opportunities for retailers. Because manufacturers pay retailers up front for some specified performance, such as prominent display or premium shelf space retailers can shirk on the contractual arrangement in a number of ways, such as

9 *See* Klein & Wright, *supra* note 3 (addressing the economics underlying the form of distribution contract).

failing to supply the desired and paid-for promotional effort, or promoting rival brands.[10]

These free-riding strategies may impose significant costs on the parties and undermine the underlying distribution contract. However, we can expect profit-maximizing transactors to attempt to minimize the costs associated with the numerous forms of dealer free-riding. It is therefore unsurprising that the normal competitive process for distribution leads to the combination of promotional contracts and restraints intended to minimize free-riding.

Exclusive dealing is one contractual mechanism by which the parties can minimize forms of dealer free-riding involving the switching of promotional effort to rival brands.[11] Exclusive dealing reduces the retailer's incentive to cheat on the promotional contract because manufacturers can easily detect violations (the presence of another product). However, exclusive dealing can be prohibitively costly where consumers have significant demand for inter-brand product variety. One would expect transactors' choice of contractual form to minimize both free-riding and loss-of-variety costs.

Category management is another contractual mechanism, related to exclusive dealing, which reduces retailer incentives to cheat on the promotional agreement. Klein and Wright illustrate that category management arrangements reflect a tradeoff of these costs that is less restrictive than exclusivity, but nonetheless has attracted unwarranted skepticism with respect to its potential for exclusionary abuse.[12] This common marketing device grants a manufacturer some level of input with respect to the retailer's shelf space allocation and product selection decisions and is pervasive in supermarkets, drugstores and bookstores.[13] Like exclusive dealing, category management reduces the retailer's ability to deviate from the specified or implied desired level of promotional performance by placing those decisions in the hands of the category manager, or lowering the costs of detection as a result of the manager's increased involvement in shelf space allocation.

The key economic insight is to identify the relationship between these two economic phenomena: manufacturer payments for promotion and exclusionary

10 Benjamin Klein & Andres V. Lerner, How Exclusive Dealing Prevents Free-Riding: An Economic Analysis of *Dentsply* (2006) (unpublished manuscript, on file with author), provides a useful taxonomy of dealer free-riding strategies. Klein and Lerner demonstrate that Howard Marvel's seminal explanation of the role of exclusive dealing in protecting manufacturer-supplied promotional investments, Howard P. Marvel, *Exclusive Dealing*, 25 J.L. & ECON. 1 (1982), incorrectly concludes that exclusive dealing does not prevent dealer free-riding on manufacturer paid-for promotional investments. To the contrary, Klein and Lerner show that exclusive dealing prevents both forms of free-riding.

11 Klein & Lerner, *supra* note 10.

12 Benjamin Klein & Joshua Wright, The Antitrust Law and Economics of Category Management (March 1, 2006) (unpublished manuscript, on file with author).

13 *Id. See also* Mary Anne Mason & Paul B. Hewitt, Category Management: An Interview with FTC Commissioner Thomas B. Leary (last modified March 28, 2005), http://www.ftc.gov/speeches/leary/050328abainterview.pdf (noting that the "extent to which the category manager actually gets into the details of promoting and pricing varies from retailer to retailer").

contractual mechanisms such as exclusive dealing and category management. Table 1 combines the economic insights presented thus far into a simple prediction of contract form focusing on two key underlying features of the distribution relationship: the degree of product-specific inter-retailer competition and consumer demand for variety.[14]

**Table 1: Distribution Arrangements**

| | | | Product-Specific Individual Retailer Price Elasticity | |
|---|---|---|---|---|
| | | | *Low* | *High* |
| Demand for Product Variety | *High* | Form of Payment | Discounts | Slotting allowances & Resale price maintenance |
| | | Cheating Prevention Mechanism | Exclusive Dealing | Exclusive Dealing |
| | *Low* | Form of Payment | Discounts | Slotting allowances & Resale price maintenance |
| | | Cheating Prevention Mechanism | Category management & partial exclusivity | Category management & partial exclusivity |

Antitrust law has failed to fully recognize the link between these contractual arrangements. The result has been significant antitrust exposure for firms engaging in each of these each practices, and a confused state of affairs in the antitrust jurisprudence of exclusionary distribution contracts.

C. *Competition for Distribution Benefits Consumers*

A question of fundamental importance to antitrust policy is whether payments to retailers resulting from competition for distribution benefit consumers. While much attention has been paid to whether these payments can

14 These are only two of several important determinants of contractual form.

deprive rivals of efficient scale or are predatory in the below-cost sense, the policy discussion has either ignored the possibility that these payments might benefit consumers or has erroneously assumed that some payments are not passed on in a competitive retail environment. This assumption has been particularly problematic in the discussion of fixed rebates such as slotting allowances, where it is often said that these payments do not create an incentive to lower retail prices and are therefore likely to be anticompetitive. For example, several economists at the Federal Trade Commission Workshop on Slotting Allowances hypothesized that the fixed form of slotting allowances implied that they would not be passed on to consumers.[15]

This view does not make economic sense in a competitive retail environment. If retailers earn a competitive rate of return, increased distribution payments should be offset by either lower retailer margins or higher retailer expenditures on non-price services. In other words, retailers are likely to invest these payments in forms of competition likely to have inter-retailer effects, such as an increase in store traffic. There is no evidence suggesting that shelf space payments have increased retailer profits. Klein and Wright illustrate that during the time period associated with drastic increases in the use of slotting allowances, beginning in 1981, retailer profitability remained constant.[16] Contrary to the frequently expressed view that payments are not passed on to consumers,[17] constant retail profits and increasing manufacturer payments imply that consumers benefit from competition for distribution.

It is important to note that the form of payment is likely to impact how, not whether, consumers benefit from competition from distribution. In other words, one should not expect a per-unit time slotting allowance paid by Coca-Cola to result in lower Coca-Cola prices. However, this does not mean that consumers do not benefit, since these dollars are passed on to consumers in the form of lower prices on some other product, or through increased non-price expenditures.

This insight presents a challenge in terms of how antitrust law should account for benefits passed on to consumers outside the relevant antitrust market. Measuring the benefits created by distribution payments in a multi-product retail environment is likely to be very difficult. Even more difficult is the prospect of evaluating these benefits against any potential anticompetitive effects. While stylized models that do not incorporate the competitive virtues of competition for distribution add to our knowledge of these practices by isolating particular economic forces, these models are not built for analyzing

15 *See, e.g.*, FED. TRADE COMM'N, REPORT ON THE FEDERAL TRADE COMMISSION WORKSHOP ON SLOTTING ALLOWANCES AND OTHER MARKETING PRACTICES IN THE GROCERY INDUSTRY 27-28, *available at* http://www.ftc.gov/os/2001/02/slottingallowancesreportfinal.pdf ; 2 Transcript of Workshop on Slotting Allowances 180-81 (June 1, 2000), *available at* http://www.ftc.gov/bc/slotting/slotting61.pdf (comments of Greg Shaffer).

16 Klein & Wright, *supra* note 3, at 17.

17 *See supra* note 15.

the tradeoffs inherent in evaluating net competitive effects. Unremarkably, these models cannot improve the design of antitrust rules by simultaneously identifying potentially anticompetitive distribution practices while protecting consumers' interests in the indirect benefits passed on to them through retail competition.[18]

While formulating a workable antitrust rule that precisely captures both of these effects is likely impossible, a reasonable first step is to design a standard that ensures consumers will receive these benefits where there is little to no risk that competition for distribution will harm competition. The first principle of such an antitrust rule must be to allow manufacturers to compete vigorously for distribution by reducing prices or, equivalently, by making payments to distributors. Antitrust policy follows this principle with respect to predatory pricing law. Because manufacturer payments for distribution result in indirect benefits to consumers that are similar to the direct benefits consumers receive from price competition, this principle ought to apply quite naturally.[19] As Judge (now Justice) Breyer explained in *Barry Wright Corp. v. ITT Grinnell Corp*., "the antitrust laws very rarely reject such beneficial 'birds in the hand' for the sake of more speculative (future low-price) 'birds in the bush.'"[20] Likewise, the certain benefits of competition for distribution suggest that such practices should be judged by a standard similar to those used to identify illegal predatory price competition.[21] To illustrate the need for a new rule, Part II describes the confused state of modern antitrust analysis of competitive practices employed in the market for product distribution.

## II. Antitrust Regulation of Competition for Distribution

Modern antitrust enforcement battles frequently concern competitive issues surrounding product distribution and promotion. Neither manufacturer purchase of distribution and promotion nor the use of vertical restraints to prevent dealer free-riding have escaped antitrust scrutiny. For example, slotting arrangements have played a central role in recent antitrust litigation,[22]

18 For a discussion of the bundling literature, including bundled rebates, see Bruce H. Kobayashi, *Does Economics Provide a Reliable Guide to Regulating Commodity Bundling by Firms? A Survey of the Economic Literature*, 1 J. COMPETITION L. & ECON. 707 (2006). [hereinafter Kobayashi, *Survey of the Economic Literature*]; Bruce H. Kobayashi, *Two Tales of Bundling: Implications for the Application of Antitrust Law to Bundled Discounts*, AEI/Brookings Joint Center Monograph (forthcoming 2006) (George Mason Univ. Sch. of Law, Law & Econ. Working Paper No. 05-27, 2005) [hereinafter Kobayashi, *Two Tales*].

19 *See* Kobayashi, *Two Tales*, *supra* note 18.

20 724 F.2d 227, 234 (1st Cir. 1983).

21 *See, e.g.*, Brooke Group Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209 (1993); Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 475 U.S. 574 (1986).

22 *See, e.g.*, Conwood Co. v. United States Tobacco Co., 290 F.3d 768 (6th Cir. 2002); FTC v. H.J. Heinz Co., 116 F. Supp. 2d 190 (D.D.C. 2000), *rev'd*, 246 F.3d 708 (D.C. Cir. 2001); FTC v. McCormick, FTC Dkt. No. C-3939 (2000).

Congressional hearings,[23] and a FTC Workshop and Study.[24] Other forms of promotional payments, market-share discounts, bundled rebates, resale price maintenance and cooperative advertising programs have not escaped challenge.[25] Attempts to reduce retailer free-riding incentives, such as exclusive dealing contracts and category management, have also been challenged. European Union antitrust law has experienced similar controversy regarding distribution arrangements.[26] This Part explores antitrust law with respect to both manufacturer payments for distribution and contractual attempts to minimize dealer free-riding on these promotional contracts.

### A. *Promotional Payments and Foreclosure Analysis*

One set of cases involves allegations that a manufacturer's payment for shelf space or promotion causes competitive harm. The common feature of these claims is the allegation that the marketing arrangements are de facto exclusive, depriving rivals of efficient scale for a significant period of time by foreclosing opportunities for product distribution. These arrangements are generally analyzed under the rule-of-reason framework, assessing whether the defendant has market power, whether the challenged conduct "forecloses competition in a substantial share of the line of commerce involved,"[27] and

23 *Slotting Fees: Are Family Farmers Battling to Stay on the Farm and in the Grocery Store?: Hearing Before the S. Comm. on Small Business*, 106th Cong. (2000); *Competitive Issues in Agriculture and the Food Industry: Hearing Before the H. Comm. on the Judiciary*, 106th Cong. (1999); *Slotting: Fair for Small Business and Consumers?: Hearing Before the S. Comm. on Small Business*, 106th Cong. (1999).

24 FTC REPORT, *supra* note 15, at 11 & nn.18-19. The FTC Report summarized the findings of a workshop held from May 31 to June 1, 2000. *See also* FED. TRADE COMM'N STAFF STUDY, SLOTTING ALLOWANCES IN THE RETAIL GROCERY INDUSTRY: SELECTED CASE STUDIES IN FIVE PRODUCT CATEGORIES (2003) [hereinafter FTC STUDY].

25 *See* In re Compact Disc Minimum Adver. Price Antitrust Litig., 138 F. Supp. 2d 25 (D. Me. 2001); In re Sony Music Distrib. Inc., Trade Reg. Rep. (CCH) ¶ 24,746 (FTC Aug. 30, 2000) (consent decree by which compact disc distributors agree to cease and desist from requiring dealers to use distributor's minimum advertised price in order to obtain cooperative advertising dollars).

26 Slotting fees and other forms of shelf space payments were also involved in Coca-Cola's recent settlement with the European Commission, which significantly limits Coca-Cola's ability to offer rebates conditioned on exclusivity or specified levels of sales, as well as the amount of shelf space that it can purchase from retailers. *See* Undertaking, Case Comp/39.116/B-2-Coca-Cola; *see also* Case T-65/98, Van den Bergh v. Comm'n, 2003 E.C.R. II-4653 (finding contractual exclusivity in the provision of ice-cream freezers in violation of Articles 81 and 82); Case T-203/01, Michelin v. Comm'n, 2003 E.C.R. II-04071 ("*Michelin II*") (finding Michelin's rebate scheme in violation of Article 82).

27 Tampa Elec. Co. v. Nashville Coal Co., 365 U.S. 320, 329 (1961). Use of exclusive dealing analysis in cases involving shelf space and promotional programs is common. *See, e.g.*, Louisa Coca-Cola Bottling Co. v. Pepsi-Cola Metro Bottling Co., 94 F. Supp. 2d 804, 816 (E.D. Ky. 1999); Beverage Mgmt., Inc. v. Coca-Cola Bottling Corp., 653 F. Supp. 1144, 1153-54 (S.D. Ohio 1986); Bayou Bottling, Inc. v. Dr. Pepper Co., 725 F.2d 300, 304 (5th Cir. 1984); *cf.* Jonathan M. Jacobson, *Exclusive Dealing, "Foreclosure," and Consumer Harm*, 70 ANTITRUST L.J. 311, 363 (2002) (arguing that "foreclosure is a concept that [antitrust] analysis has largely forgotten," and that courts focus instead on whether the exclusive dealing contracts increase the defendant's market power). However, the economic logic of "raising rivals' costs" implies that distribution contracts cannot increase the defendant's market power without depriving a rival of efficient scale. Jacobson does concede that the foreclosure inquiry remains useful "as a screening device" in those cases "in which the factfinder is asked to infer

whether there is likely to be competitive harm. The fundamental economic inquiry in promotional payment cases is whether rivals are sufficiently disadvantaged by the promotional program that they are unable to achieve minimum efficient scale for a significant period of time. These conditions must hold for a monopolist to increase barriers to entry.

A leading case addressing this issue involves Philip Morris ("PM") and its "Retail Leaders" program.[28] Retail Leaders, introduced in October 1998, involved four different "participation levels" corresponding to both the magnitude of PM payments and the amount of advantageous display space provided to PM. At the highest two levels of Retail Leaders, PM not only made promotional payments to retailers but also granted retailers an "industry fixture" that would occupy a specified percentage of total display space for cigarettes. At the highest level, this percentage was 100%. At the mid-level of Retail Leaders, the industry fixture would occupy half of the total category display space, specifying that PM brands were to be allocated proportionately to PM's market share (otherwise known as a "space-to-sales" allocation). The other half of category space was to be divided between a "prime fixture" constituting approximately 25% of category space and promoting only PM brands and a "retailer's choice fixture" which would occupy the remaining 25% of the space and contain competing brands and signage.[29]

Several other details of the Retail Leaders program warrant mention. First, PM paid retailers with per-unit discounts known as retail display allowances ("RDAs").[30] Second, it was undisputed that Retail Leaders contracts were terminable at will without penalty upon thirty days' notice.[31] Third, under each Retail Leaders level of participation, retailers were never required to grant PM more than "space-to-sales," or a greater percentage of shelf space than its market share.[32]

Several tobacco companies challenged Retail Leaders under both sections 1 and 2 of the Sherman Act. The court, after initially issuing a preliminary injunction in favor of the plaintiffs, granted Philip Morris's motion for summary judgment, dismissing the case on the grounds that PM did not have market power, and alternatively, that the Retail Leaders program did not sufficiently foreclose rivals from the market. Specifically, the court found that Retail Leaders foreclosed only 34% of the market, that plaintiffs successfully

competitive harm from the fact that a large percentage of the relevant market has been tied up by the challenged agreement." *Id*. This exception may swallow the rule, as distribution cases frequently require the factfinder to make exactly this inference.

28 R.J. Reynolds Tobacco Co. v. Philip Morris Inc., 199 F. Supp. 2d 362 (M.D.N.C. 2002) ("*RJR II*"), *aff'd per curiam*, 67 F. App'x 810 (4th Cir. 2003).

29 *Id*. at 370.

30 *Id*. at 369-70.

31 *Id*. at 371.

32 *Id*. at 370.

competed against PM for premium shelf space and signage, and that retailers were able to terminate agreements at will.[33]

The result makes economic sense. In promotional payment cases, manufacturer payments will be passed on to consumers through retail competition.[34] Competition between tobacco manufacturers resulted in a boon to consumers as RDAs were passed on in the form of lower prices.[35] While anticompetitive foreclosure is a viable concern, the key policy requirement is that the competitive process for distribution is left "open," meaning that rival manufacturers have the opportunity to bid for shelf space. This condition is clearly satisfied where contracts are of short duration and easily terminable like those in the Retail Leaders program.[36] In fact, it appears that PM's relative prices fell after the implementation of Retail Leaders, suggesting that the program was pro-competitive.[37]

*RJR II* illustrates the standard framework in exclusionary distribution cases, requiring plaintiffs to show monopoly power and substantial foreclosure and focusing on whether the duration of contract prohibits competitive bidding by rivals. *RJR II* also highlights one of the interesting challenges for antitrust in the context of complex promotional programs designed to increase a manufacturer's shelf space or display presence: the differential "substantial foreclosure" analysis in cases involving payments for shelf space. In addition to addressing this issue, I will also briefly address how the availability of Robinson-Patman Act as an alternative enforcement method affects the regulation of distribution practices and how the competition for distribution perspective informs the current debate on bundled rebates triggered by the recent Third Circuit decision in *LePages*.[38]

33 *Id.* at 391 ("Because Retail Leaders agreements are terminable at will with thirty days notice, retail product and display space are subject to uninterrupted competitive bidding, and Plaintiffs are not substantially foreclosed from the relevant market.").

34 *Supra* Part I.C. Grocery retailer profitability has remained largely unchanged, with after tax profits as a percentage of assets averaging 4.53% during 1980-83 and only 4.15% during 1983-97. Klein & Wright, *supra* note 3, at 17. These results are consistent with the conclusion that competition has continued in the grocery retail market despite significant increases in retail grocery concentration over the past two decades. *See* Joshua Wright, Vons Grocery *and the Concentration-Price Relationship in Grocery Retail*, 48 UCLA L. REV. 743 (2001).

35 R.J. Reynolds's economic expert conceded this point during the litigation. *RJR II*, 199 F. Supp. 2d at 369-70. The fact that PM paid significant promotional payments is consistent with the very high margins on tobacco products, giving tobacco manufacturers the incentive to pay for premium shelf space and signage that might induce incremental sales.

36 The court made exactly such a finding. *Id.* at 391. Whether short-term agreements do not have substantial anticompetitive effects as a matter of law is an open issue subject to debate across the circuits. See cases cited *infra* note 115.

37 *See* Peter Bronsteen et al., *Price Competition and Slotting Allowances* (2005) (forthcoming in ANTITRUST BULL.).

38 LePage's, Inc. v. 3M, 324 F.3d 141, 146 (3d. Cir. 2003), *cert. denied*, 124 S. Ct. 2932 (2004).

Desktop Publishing Example

1. Shelf Space Foreclosure and "Space-to-sales"

Courts sometimes analyze foreclosure levels differently in shelf space cases than in other foreclosure cases. One commentator summarizes current antitrust law as "routinely sustain[ing] the legality of exclusive dealing arrangements with foreclosure percentages of 40 percent or less."[39] In the shelf space context, courts have frequently substituted the "*space-to-sales*" ratio as a rule of thumb for substantial foreclosure rather than adhering to the established 40% levels or some other fixed percentage. The space-to-sales rule concludes that a dominant firm has achieved substantial foreclosure when it enters promotion contracts that require retailers to supply a percentage of category shelf space exceeding manufacturer's market share.

This rule likely owes its roots to an FTC investigation of ready-to-eat cereals.[40] Subsequent to that investigation, federal courts have frequently used the "space-to-sales" rule as a guideline in monopolization cases involving manufacturer discounts and slotting fees paid to retailers.[41] In *RJR II*, PM persuaded the court that foreclosure was not likely because PM obtained space in an amount "equal or less than its market share" and sometimes "only 90% of its share of product space," whereas RJR obtained contracts granting significantly more space than its market share.[42]

The space-to-sales ratio substitutes sophistication and accuracy for convenience and ease of calculation. Were a comparison of market share to shelf share an accurate indicator of potential for competitive harm, perhaps the ratio would be defensible. It is not. An inference of competitive injury derived solely from the fact that one firm is able to obtain distribution share greater than its market share is likely to lead to problematic results.

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39 Jacobsen, *supra* note 27, at 324 n.85. Professor Hovenkamp suggests 20% as the minimum foreclosure percentage and 50% as a level at which courts should routinely condemn foreclosure. *See* HERBERT HOVENKAMP, ANTITRUST LAW: AN ANALYSIS OF ANTITRUST PRINCIPLES AND THEIR APPLICATION para 1821c, at 160 (2005).

40 *See In re* Kellogg Co., 99 FTC 8 (1982). Factual findings 460 and 461 in that case supported "space-to-sales," or allocation of shelf space in proportion to market share, as a method that "ensured that the retailers would avoid out-of-stocks and over-stocks, increase their efficiency and profitability and reduce labor costs." *Id.* at para. 460. The findings of fact also stated that "[s]ales volume is, and has been, the basic method of space allocation throughout grocery stores." *Id.* at para. 461.

41 In *Frito Lay, Inc. v. Bachman Co.*, 659 F. Supp. 1129, 1134 (S.D.N.Y. 1986), the court dismissed a section 1 claim due to failure to allege that Frito Lay's contracts obtained a greater share of shelf space than its market share warranted. The Fifth Circuit rejected a similar monopolization claim using the "space-to-sales" guideline in *Bayou Bottling v. Dr. Pepper*, 725 F. 2d 300, 304 (5th Cir. 1985). *See also* Louisa Coca-Cola Bottling Co. v. Pepsi-Cola Metro Bottling Co., 94 F. Supp. 2d 804, 816 (E.D. Ky. 1999); Beverage Mgmt., Inc. v. Coca-Cola Bottling Corp., 653 F. Supp. 1144, 1153-54 (S.D. Ohio 1986).

42 199 F. Supp. 2d at 388, 390. PM's appellate brief argues that PM did not substantially foreclose the market because "Philip Morris receives only its market share of display and advertising space," "PM asks for no more than space-to-sales proportionality," and "space-to-sales marketing strategies such as this are a 'common place tool for competitors' and are wholly lawful," citing *Frito Lay* and *Bayou Bottling*. Brief of Appellee at 48-51, 199 F. Supp. 2d 362 (2002) (No. 02-1295) (quoting Frito Lay, 659 F. Supp. 2d at 1134, and citing Bayou Bottling, 725 F.2d at 304).

The key foreclosure inquiry for both courts and economists is whether competitors are prevented from reaching minimum efficient scale for a significant period of time. The answer requires evidence of manufacturer-level scale economies, ease of entry, availability of alternative methods of distribution, and duration of the marketing arrangements. These conditions necessarily vary by industry and require the type of hands-on analysis conducive to rule-of-reason analysis. Rules of thumb such as space-to-sales are surely useful marketing tools for retailers determining shelf space allocation, but are just as certainly misguiding and inaccurate tools for antitrust analysis.[43]

Further, use of the space-to-sales ratio injects additional uncertainty into the product distribution equation for manufacturers with monopoly power. The set of distribution practices such a manufacturer is able to use to defend its monopoly position under a space-to-sales regime is likely to be very different than those under a typical foreclosure rule. This additional layer of uncertainty in distribution cases is likely to deter consumer welfare enhancing distribution contracts in an effort to avoid uncertain antitrust liability.

2. Robinson-Patman Liability

The Robinson-Patman Act ("the Act") prohibits certain discriminatory pricing and promotional programs in connection with the sale and distribution of products in the United States.[44] The Act is complex, its application is confusing, and its role in regulating the competitive process for distribution is unclear. This subsection does not purport to provide an exhaustive review of its application.[45] I focus solely on summarizing the Act's application to promotional shelf space payment programs.

A brief introduction to the Act's provisions is in order. Section 2(a) of the Act is applicable to discrimination in prices that adversely affects competition.[46] Section 2(c) prohibits dummy brokerage and has been applied to commercial bribery and sham transactions.[47] Sections 2(d) and 2(e) prohibit discriminatory promotional programs or discriminatory granting of allowances, services or facilities in connection with the resale of a product.[48] Finally, section 2(f) prohibits a buyer from knowingly inducing or receiving a discriminatory price.[49] Plaintiffs must prove competitive injury regardless of the provision under which their claim falls. However, the Act allows plaintiffs

43 Contracts specifying large percentage shelf space requirements, including space-to-sales contracts, may allow manufacturers to commit to providing sufficient variety while limiting dealer's free-riding incentives.

44 15 U.S.C. §§ 13-13b, 21a (2000).

45 *See generally* Barbara O. Bruckman, *Discounts, Discrimination, and Exclusive Dealing: Issues Under the Robinson-Patman Act*, 68 ANTITRUST L.J. 253 (2000).

46 15 U.S.C. § 13(a) (2000).

47 *Id.* § 13(c).

48 *Id.* § 13(d), 13(e).

49 *Id.* § 13(f).

to prove competitive injury at one of three levels, depending on the type of promotional activity involved and on the provision under which the plaintiff brought the action.[50]

Plaintiffs may bring Section 2(a) claims against manufacturer promotional programs that encourage product purchases, maintain adequate inventory, or monitor product sales.[51] In rival supplier cases, the section 2(a) standard is analytically similar to the predatory pricing standard, as plaintiffs must generally show competitive harm in the form of below-cost pricing and likely recoupment, the standard for a primary-line injury.[52] Disfavored retailers may also successfully bring claims under section 2(a) challenging a promotional program by proving second-line injury, i.e. evidence that the disfavored retailer was harmed relative to favored retailers.[53]

Section 2(c) prohibits "any person . . . to pay or grant, or to receive or accept, anything of value as a commission, brokerage, or other compensation, or any allowance or discount in lieu thereof, except for services rendered in connection with the sale or purchase of goods . . . ."[54] Section 2(c) has been suggested as an alternative approach to challenging slotting arrangements given the difficulties of proving competitive injury associated with section 2(a) claims, though section 2(c) cases have had highly variable outcomes.[55] Some courts have declined to extend section 2(c) to slotting allowances and incentive programs that are more properly analyzed under sections 2(a), 2(d), 2(e), or the Sherman Act.[56]

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50 The Robinson-Patman Act specifies three levels of competitive harm. Primary line injury is akin to the competitive injury in monopolization cases, i.e., injury to competition in the upstream market. Secondary-line injury may be shown between favored and disfavored customers, i.e., the "injury" of a retailer receiving less favorable allowances than other retailers may be sufficient to state a claim in a secondary-line case. Finally, tertiary line injury occurs between the retailers' customers.

51 Though the language of section 2(d) appears to apply more naturally to claims involving payment for preferential shelf space or promotion, several recent cases indicate that courts are also willing to analyze these cases under section 2(a).

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

53 In *Hygrade Milk*, for example, the court analyzed a group of plaintiff-distributors claims against Tropicana's distribution practices under section 2(a). Hygrade Milk & Cream Co. v. Tropicana Prods., Inc., 1996-1 Trade Cas. (CCH) ¶ 71,438 (S.D.N.Y. 1996). The plaintiff-distributors attacked Tropicana's pricing promotions, including the failure to offer slotting allowances to the plaintiffs' retailer-customers. Though the court mistakenly addressed whether the distributors' customers paid different prices for the product rather than whether the distributor paid a higher price than direct buying retailers, which would have properly established tertiary line injury, the claim was allowed to proceed under sections 2(a) and 2(d). *Id.*

54 15 U.S.C. § 13(c).

55 In *Zeller Corp. v. Federal-Mogul Corp.*, 1999-1 Trade Cas. (CCH) ¶ 72,522, 1999 U.S. App. LEXIS 6345 (6th Cir. 1999), the Sixth Circuit dismissed a claim alleging that a signing bonus not requiring additional services fell within section 2(c), while the court in *Atlantic Coast Vess Beverages, Inc. v. Farm Fresh, Inc.*, No. 3:93CV284 (E.D. Va. 1993), found a slotting fee payment in violation of section 2(c).

56 *See* Lupia v. Stella D'Oro Biscuit Co., 586 F.2d 1163, 1169-70 (7th Cir. 1998); Empire Rayon Yarn Co. v. Am. Viscose Corp., 364 F.2d 491, 492 (2d Cir. 1966) (en banc); *cf.* Yeager's Fuel, Inc. v. Pa. Power & Light Co., 953 F. Supp. 617, 665 (E.D. Pa. 1997) (holding that the case "would implicate § 2(c) if [defendant] paid special consideration to the buyer, an agent of the buyer, or an intermediary subject to the buyer's control [to influence its buying decision]"). In *Augusta News Co. v.*

Section 2(d) applies to payments for preferential shelf space or in-store positioning and seems to be the provision most naturally applied to distribution payments.[57] However, it is unclear whether manufacturers have standing to challenge rivals' promotional programs.[58] Retailers, on the other hand, may bring a section 2(d) claim by showing either primary-line or secondary-line injury.[59] Importantly, proof of discriminatory allowances causing the plaintiff to lose sales to the favored retailer and reduction in the plaintiff's profits are each sufficient to prove competitive injury under this standard.

The Act leaves private plaintiffs and enforcement agencies with the more favorable secondary-line injury standard and leaves manufacturers with a thorny maze of compliance issues. The availability to enforcement agencies of the more lenient secondary-line injury standard might be defended on the grounds that it is rarely used, but this is not a compelling defense of the Act.[60] Even sparing application of the Act is likely to reduce consumer welfare by increasing competition for distribution. Further, as illustrated by the recent FTC action against McCormick Spice Company, it remains a weapon within the arsenal of the agencies.

**Comment:** Increasing or decreasi

*McCormick* was brought under section 2(a) of the Act. McCormick is the largest American supplier of spices to grocery stores.[61] The company's leading rival, Burns Philip Food, Inc. ("Burns"),[62] instigated a price war in the early 1990s. McCormick responded to the price decrease by offering increased discounts and a variety of other payments to retailers.[63] The company's payment programs commonly included partial exclusivity requirements. In some cases, McCormick and the retailer agreed that the latter would provide

*Hudson News Co.*, 269 F.3d 41 (1st Cir. 2001), the court refused to apply section 2(c) to analyze a newspaper distributor's practice of offering large, up-front per-store fees in exchange for exclusivity, recognizing that the distributor payments were "simply price reductions offered to the buyers for the exclusive right to supply a set of stores under the multi-year contracts." *Id.* at 45.

57 *See* Frito-Lay, Inc. v. Bachman Co., 659 F. Supp. 1129, 1139-40 (S.D.N.Y. 1986) (slotting payments may be analyzed under Section 2(a) or Section 2(d)); Mary L. Azcuenaga, Comm'r, Fed. Trade Comm'n, The Robinson-Patman Act: A Perspective from the FTC, Remarks before the ABA Section of Antitrust Law and Corporate Counsel Center, Northwestern University School of Law (May 13, 1993) ("Slotting allowances . . . to obtain access to a store in connection with the initial sale . . . generally are analyzed as plain vanilla discounts . . . under Section 2(a) . . . . Slotting allowances . . . for preferential display space . . . generally are analyzed [under Section 2(d)]").

58 *See* Ashkanazy v. I. Rokeach & Sons, Inc., 757 F. Supp. 1527, 1553-54 (N.D. Ill. 1991); Frito Lay, 659 F. Supp. at 1140-41.

59 *See, e.g.*, Hygrade Milk, *supra* note 53.

60 Professor Hovenkamp recently testified to the Antitrust Modernization Commission in favor of repealing the Act, while recognizing that this option is unlikely to be politically feasible. *See* Herbert Hovenkamp, Written Testimony on the Robinson-Patman Act (July 2, 2005), *available at* http://amc.gov/commission_hearings/pdf/Hovenkamp.pdf ("as currently enforced [the Act] is a socially costly statute that produces no benefits to competition that could not be secured by means of litigation under the Sherman Act.").

61 McCormick & Co., Inc., FTC File No. 961-0050, Dissenting Statement of Commissioners Orson Swindle and Thomas B. Leary (hereinafter "Dissenting Statement"), http://www.ftc.gov/05/2000/05/mccormickswindlelearystmt.htm.

62 *Id.*

63 *Id.*

90% of its shelf space devoted to spices to the company.[64] McCormick signed more than 2000 contracts with retailers, accounting for the majority of spice sales in the United States.[65]

The FTC rejected the possibility of alleging a primary-line theory, which would require a showing that the discriminatory prices charged by McCormick were below-cost and that McCormick had a reasonable prospect of recouping its losses,[66] in favor of the secondary-line injury theory that McCormick's discriminatory pricing decreased disfavored retailers' capacity to compete against favored retailers. As evidence of this claim, the FTC pointed to five specific instances where McCormick charged higher prices to certain grocery stores than it charged to their competitors.[67] Over the dissent of two Commissioners, McCormick ultimately agreed to a consent order with the FTC preventing its use of discriminatory prices between retailers.[68]

One cynical explanation of the Commission's choice to bring the case on a secondary-line theory was that the Commission could not prevail under the more stringent primary-line standard.[69] It is difficult to assess the validity of this claim. In particular, it is unclear what percentage of total distribution McCormick contracts, which required participating retailers to dedicate up to 90% of their spice category shelf space to McCormick's products, foreclosed

64 McCormick & Co., Inc., FTC File No. 961-0050, Complaint, ¶ 12 [hereinafter Complaint]. The complaint actually alleges that McCormick discriminated in price "in no fewer than five instances . . . by providing different deal rates consisting of preferential upfront 'slotting'-type payments or allowances, discounts, rebates, deductions, free goods, or other financial benefits to some purchasers of McCormick products including, but not limited to, McCormick's spice line. . . ." Id. The complaint also alleges that the different "net price" paid by favored purchasers "were not justified by a good faith attempt to meet the equally low price of a competitor, nor were the favorable spices justified by a cost savings associated with doing business with the favored retailer." *Id.* at ¶ 13.

65 Dissenting Statement, *supra* note 61, at n.1 (citing Press Release, McCormick & Company, Inc. McCormick Signs Settlement Agreement with Federal Trade Commission (Feb. 3, 2000)). *See also* Complaint, *supra* note 64, at ¶ 5.

66 This is the traditional predatory standard articulated in Brooke Group Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209 (1993).

67 Complaint, *supra* note 64, at ¶ 12. The Commission was therefore only required to show competitive harm by one of two ways: (1) directly showing the disadvantage to disfavored retailers; or (2) indirectly through the *Morton Salt* inference. The *Morton Salt* inference allows a finding of injury to competition when a persistent price differential exists in a market where margins are low and competition is intense. Fed. Trade Comm'n v. Morton Salt Co., 334 U.S. 37, 50-51 (1948).

68 Commissioners Swindle and Leary viewed the application of the *Morton Salt* inference as inappropriate where the FTC does not also allege that larger buyers are receiving lower prices than smaller buyers. Dissenting Statement, *supra* note 61. The Commissioners' argument makes economic sense. If discounts were granted to favored purchasers as a result of the Burns price war, rather than as a function of purchasing power, there is no reason to infer that favored stores received discounts across all grocery products. The Commission majority goes to great lengths to point out that it relied not only on the *Morton Salt* inference, but also upon evidence that McCormick was the largest supplier of spices in the United States and demanded large percentages of shelf space from retailers. But these facts are irrelevant to the *Morton Salt* inquiry. Assuming *arguendo* that McCormick's ability to extract exclusivity from retailers was a function of monopoly power, such dominance does not imply that the retailers receiving the largest payments from McCormick were also likely to receive larger payments from other suppliers. Simply put, the dissenting Commissioners argue that McCormick was a primary-line case argued on a secondary-line theory.

69 *See Brook Group*, 509 U.S. 209 (1993).

from rivals. However, the primary line claim may have also been unsuccessful if the contracts were of short duration. While there is no direct evidence of the duration of these contracts, most slotting arrangements are six months to one year in duration, therefore falling within the presumptive safe harbor in most jurisdictions.[70]

What of the exclusive nature of McCormick's marketing arrangements emphasized by the FTC? The complaint alleged:

> McCormick has commonly included provisions that, much as is sometimes seen with slotting allowances, restrict the ability of customers to deal in the products of competing spice suppliers. Such provisions typically demand that the customer allocate the large majority of the space devoted to spice products – in some case 90% of all shelf space devoted to packaged spices, herbs, seasonings and flavorings of the kinds offered by McCormick – to McCormick.[71]

Chairman Pitofsky defended the Commission's position by pointing to McCormick's market power and the "fact that discounts to favored chains were conditioned on an agreement to devote all or a substantial portion of shelf space to the McCormick line of products."[72] The observation that promotional payments are frequently observed alongside exclusivity provisions is inappropriately cited in support of the conclusion that this combination makes anticompetitive inferences appropriate.

To the contrary, this combination is entirely unremarkable because exclusionary distribution terms are used to minimize the costs associated with dealer free-riding on the manufacturer's promotional payments, which solve a pervasive dealer undersupply problem with respect to promotional effort. These vertical restraints enhance the transactors' abilities to facilitate promotional performance under the contract.

The availability of the Act's weaker standard suggests a backdoor for plaintiffs unable to meet the more stringent burden of proving competitive injury in a monopolization or primary-line claim. While it is doubtful that the FTC's prosecution of McCormick represents a revitalization of the Act, the prosecution does create uncertainty for manufacturers in the growing number of industries relying on retailer promotional effort and product placement for sales.

### 3. Bundled Rebates as Competition for Distribution

In the wake of the Third Circuit's ruling in *LePage's, Inc. v. 3M Co.*[73] holding 3M liable under section 2 for offering retailers bundled rebates in

70 FTC STUDY, *supra* note 15, at iii n. 14; FTC REPORT, *supra* note 24, at 11.

71 Complaint, *supra* note 64, at ¶ 10.

72 McCormick & Co., Inc., FTC File No. 961-0050, Statement of Chairman Robert Pitofsky, and Comm'rs Sheila F. Anthony and Mozelle W. Thompson (hereinafter "Majority Statement"), *available at* http://ftc.gov/os/2000/03/mccormickrpslamwtstatement.htm.

73 324 F.3d 141 (3rd Cir. 2003), *cert. denied*, 542 U.S. 953 (2004).

exchange for the purchase of increasing portions of its product line, the role of bundled rebates in raising barriers to entry has been a frequently discussed topic in the antitrust literature.[74] The antitrust literature has subsequently focused attempts to articulate tests capable of identifying consumer welfare-decreasing bundled rebates.[75]

Nalebuff, for example, argues that exclusionary bundling occurs when the incremental price of an *XY* bundle over the standalone *Y* price is less than the bundler's long run average variable costs of *X*. When *X* and *Y* are consumed in variable proportions, the competitive price of *X* minus the implied discount on *X* required to retain consumers must be above the monopolist's long run average variable costs. This is the test adopted in *Ortho Diagnostics Systems v. Abbott Labs*.[76] Greenlee et al. propose a test that would condemn bundled rebates where the stand alone price of *Y*, where available, is greater than the monopoly price in the non-bundling equilibrium. While these models are useful in terms of identifying the possibility of exclusionary bundled rebates, the implications of these models for antitrust law are less clear because they do not consider other efficiency reasons for the practice and are equivocal in their conclusions regarding welfare.

The primary challenge facing the creation of an antitrust rule that would successfully identify promotional practices that decrease consumer welfare on net is that such a rule must account for the pass-through of manufacturer payments to consumers, as well as other possible efficiency benefits. The existing models of exclusionary bundling purposefully ignore these potential benefits and fail to offer a methodology for calculating the trade-off between consumer benefits and the potential for consumer harm.

Viewing bundled rebates as a form of competition for distribution adds to the antitrust analysis. Bundled rebates, like slotting allowances and discounts, may be viewed as a method to compensate distributors for providing promotion that would not otherwise occur and are likely to be an important component of the competitive process where consumers are sensitive to point-of-sale services

74 *See, e.g.*, Barry Nalebuff, *Bundling as a Barrier to Entry*, 119 Q.J. ECON. 159 (2003) [hereinafter Nalebuff, *Barrier to Entry*]; Steya Kolay et al., *All-Units Discounts in Retail Contracts*, 13 J. ECON. & MGMT. STRATEGY 429 (2004); Barry Nalebuff, Bundling, Tying, and Portfolio Effects (United Kingdom Dep't of Trade & Indus., Economics Paper No. 1, 2003) [hereinafter Nalebuff, Portfolio Effects]; *see also* Kobayashi, *supra* note 18, *Survey of the Economic Literature* (giving a useful survey of these and other bundling models).

75 *See, e.g.*, Daniel A. Crane, *Multi-Product Discounting: A Myth of Non-Price Predation*, 72 U. CHI. L. REV. 27 (2005); *Barrier to Entry, supra* note 74; Patrick Greenlee et al., *An Antitrust Analysis of Bundled Loyalty Discount*s (Justice Department, EAG Discussion Paper, EAG 04-13, 2004). These tests are discussed at length in Kobayashi, *Two Tales, supra* note 18. *See also* Letter from Timothy J. Muris, Professor, George Mason University School of Law, to Deborah A. Garza, Chair, Antitrust Modernization Commission (July 15, 2005) (reviewing the modern industrial organization literature and concluding that it "does not supply a reliable way to distinguish uses of bundling that are on net procompetitive from those that are anticompetitive") (on file with author).

76 920 F. Supp. 455 (S.D.N.Y. 1996).

and incremental sales are highly profitable. Further, it is important to note that bundled rebates are passed on from competitive retailers to consumers.

An economic analysis of bundled rebates mapping into an administrable antitrust rule is likely to require fact-intensive analysis rather than abstract and highly stylized modeling. I do not dispute the results of models finding some exclusionary effect under the assumption that bundling does not create consumer benefits.[77] The goal of this discussion is not to provide a general theory of bundled rebates, but simply to show that bundled rebates are similar to substitute forms of competition for distribution, such as slotting and quantity discounts, which are efficiency-enhancing methods of increasing highly profitable promotional sales.[78]

Viewing bundled rebates as part of the competitive process for distribution leads one, when assessing competitive effects, to focus on the question of whether this process is open to rivals, rather than whether the conditions of stylized models have been satisfied. I believe such a shift in focus would be an improvement for antitrust policy as a general matter, as there is a void of empirical evidence suggesting that practices satisfying the conditions of these models cause a decrease in consumer welfare. A first principle of regulation of the competitive process for distribution should be to limit liability to situations where rivals are not able to compete for distribution on equal footing with the dominant firm.

### B. *Exclusivity and Category Management as Bad Conduct*

The competitive process for distribution frequently involves the use of exclusionary terms that have also been the subject of antitrust challenge. *Continental T.V., Inc. v. GTE Sylvania* requires such non-price vertical restraints to be analyzed under the rule of reason.[79] Antitrust analysis of vertical

77 Timothy Muris describes the state of the modern industrial organization economics as "justif[ying] concern about virtually any practice." Muris, *supra* note 75, at 73. It is important to note that even under the narrow conditions of the exclusionary bundling models, consumer welfare typically increases in the bundling equilibrium. *See, e.g.*, Nalebuff, *Barrier to Entry*, *supra* note 74; Timothy J. Brennan, *Is Competition the Entry Barrier? Consumer and Total Welfare Benefits of Bundling* (Oct. 24, 2005) (unpublished manuscript, on file with author). Proponents of these models argue that short-run consumer welfare benefits increase to the expense of long run anticompetitive effects that are generally not captured in the model. Carlton and Waldman incorporate dynamic effects into their tying model but warn against relying on these models to design antitrust policy. Dennis W. Carlton & Michael Waldman, *How Economics Can Improve Antitrust Doctrine Towards Tie-In Sales*, 1 COMPETITION POL'Y INT'L 27, n.31 (2005); Dennis W. Carlton & Michael Waldman, *The Strategic Use of Tying to Preserve and Create Market Power in Evolving Industries*, 33 RAND J. ECON. 194, 215 (2002).

78 *See also* Kobayashi, *Survey of the Economic Literature*, *supra* note 18, at 708 ("bundled discounts give retailers strong incentives to promote and sell the manufacturer's goods and services, and can mitigate retailer free-riding and other types of agency problems. Thus, bundled discounts can serve the same efficiency-promoting vertical control functions as have been identified in the economic literature on tying, exclusive dealing, and other forms of vertical restraints"); Muris, *supra* note 75, at 17 ("[b]undled rebates, therefore, can serve the same efficiency-promoting functions as has been identified in the literature examining the use of exclusive dealing and other forms of vertical restraints").

79 433 U.S. 36 (1977).

non-price restraints has remained faithful to *Sylvania*'s teachings by focusing on the "market impact" of the restraints. Economic theory suggests that exclusionary contracts may have an anticompetitive market impact when they raise a rival's costs by depriving the rival of the opportunity to achieve efficient scale for a significant period of time.

A number of necessary economic conditions follow from this theory. The most frequently discussed condition in this analysis is foreclosure. Foreclosure of a share of distribution sufficient to force a manufacturer's rivals to operate at less than minimum efficient scale will result in a cost disadvantage to existing competitors and potential entrants. If this condition persists for a significant duration of time, competitive injury can occur as the duration of the monopolist's reign is extended. Exclusive dealing jurisprudence has, in large part, embraced an analytical approach that is consistent with economic theory. One commentator notes that modern decisions generally attach liability only upon foreclosure greater than 40% for liability.[80]

Even where foreclosure does not exceed 40%, however, antitrust liability often attaches in the absence of a reasonable pro-competitive justification. In many cases, the most frequently recognized justification for use of exclusivity, protection of manufacturer-supplied investments, does not fit the facts. When there is no immediately apparent pro-competitive rationale for exclusivity, courts frequently shift the liability burden to the firm using the exclusive contract on the grounds that competition does not appear to be occurring on the merits. This narrow search for efficiency justifications is partially attributable to economists' failure to explain the broader set of free-riding problems confronting manufacturers and retailers.[81]

As described in Part I, exclusionary contracts play an important role in minimizing a broad set of free-riding incentives inherent in retail promotion contracts, and not simply the Telser-type, discount free-riding problems frequently accepted by courts as an efficiency justification. Distribution contracts including exclusionary terms frequently do not involve the type of manufacturer investments that lend themselves to discount free riding. Consumers are not likely to frequent a retailer supplying premium shelf space to a particular product before purchasing it at a "no frills" retailer. Rather, exclusivity in these contracts minimizes costs associated with dealer free-riding on manufacturer promotional payments by either pocketing the payments without supplying the desired services or promoting rival brands.

80 Jacobsen, *supra* note 27, at 318.

81 Retailers will find it uneconomical to supply promotional effort where the presence of discounters threatens to eliminate the return to the retailers' investment. Customers consume the promotional services at the full-service retailer before purchasing the item for a lower price at the discounter. Solving this type of free-riding, analyzed by Lester G. Telser in his classic article, *Why Should Manufacturers Want Fair Trade?*, 3 J.L. & ECON. 86 (1960), is the only justification for exclusionary distribution contracts discussed in the recent FTC Report. FTC REPORT, *supra* note 15, at 39.

Business school students are commonly taught that producers use exclusive dealing where they "hope to obtain more dedicated and knowledgeable selling."[82] Manufacturers frequently assert that these agreements increase dealers' dedication to their product, and similar defenses have been recognized in a handful of antitrust cases, although there is no formalized economic explanation in the cases for the role of exclusive dealing in increasing dealer loyalty.[83]

Category management practices have also been challenged under section 2 of the Sherman Act. When viewed from the competition for distribution perspective, category management is a far less suspicious practice than has been suggested.[84] Again, because shelf space payments also create dealer free-riding incentives, transactors will seek devices to minimize these free-riding costs and facilitate valuable promotional performance. Category management is one such mechanism, allowing manufacturers to minimize these free-riding costs without resorting to an exclusive dealing term, which retailers may find prohibitively costly when consumer demand for variety is substantial.

### C. *Operationalizing Naked Exclusion*

The narrow view of the role of exclusionary contracts in preventing free-riding frequently runs the risk of treating efficient distribution contracts as "naked" attempts at exclusion, found to violate the antitrust laws without a full-blown inquiry into their market impact.[85] For example, the *Microsoft* court appears to prematurely shift the liability burden to the defendant as a result of the failure to produce a persuasive business justification for its exclusive dealing contracts with Internet access providers.[86] Notably, the burden shifted

82 KOTLER, *supra* note 2, at 513.

83 *See, e.g.*, Roland Mach. Co. v. Dresser Indus., 749 F.2d 380, 395 (7th Cir. 1984); Sulmeyer v. Coca-Cola Co., 515 F.2d 835, 840 n.2 (5th Cir. 1975) ("exclusive dealing leads dealers to promote each manufacturer's brand more vigorously than would be the case under nonexclusive dealing"); Hendricks Music Co. v. Steinway, Inc., 689 F. Supp. 1501 (N.D. Ill. 1988); Joyce Beverages v. Royal Crown Cola Co., 555 F. Supp. 271 (S.D.N.Y. 1983). Klein & Lerner, *supra* note 10, show that exclusive dealing solves free-riding problems associated with the more general phenomenon of insufficient dealer promotion by giving dedicated dealers the incentive to promote. *See also* Benjamin Klein, *Exclusive Dealing as Competition for Distribution on the Merits*, 12 GEO. MASON L. REV. 119 (2003).

84 *See* Klein & Wright, *supra* note 12.

85 Conduct that harms rivals and is without an intuitive business justification is frequently defined negatively as "not competition on the merits," following the famous formulation of Professors Areeda and Turner. *See, e.g.*, Aspen Skiing Co. v. Aspen Highlands Skiing Corp., 472 U.S. 585, 595-97, 605 & n.32 (1985) (quoting P. AREEDA & D. TURNER, ANTITRUST LAW 78 (1978)). This may also describe the state of European Community doctrine where abuse of a dominant position is roughly defined as conduct by a dominant firm that both (1) hinders competition and (2) is not "normal competition." Case 85/76, Hoffman-La Roche & Co. AG v. Comm'n, 1979 E.C.R. 461 paras. 89-91 (1979). Many commentators have criticized this distinction as mysterious, vacuous and problematic. *See, e.g.*, Einer Elhauge, *Defining Better Monopolization Standards*, 56 STAN. L.REV. 253, 265-66 (2003).

86 *See* United States v. Microsoft Corp., 87 F. Supp. 2d 30, 52-53 (D.D.C. 2000), *aff'd in part, rev'd in part*, 253 F.3d 34 (D.C. Cir. 2001).

despite the fact that the foreclosure was nominally below 40%.[87] Other commentators have noted that defendants with market power rarely prevail in exclusionary distribution cases by asserting a valid business justification after the plaintiff meets its prima facie burden.[88]

*Conwood Co. v. United States Tobacco Co.*[89] fits this pattern. United States Tobacco was category manager in a number of retail outlets and therefore had significant input with respect to product allocation, as well as in-store marketing decisions. Conwood alleged that United States Tobacco injured competition by: (1) removing and destroying competitors' display racks without permission of store management; (2) training its salespeople to take advantage of store clerks; (3) providing misleading information to retailers in order to trick them into believing that United States Tobacco's products were better selling; and (4) entering into exclusive agreements with retailers.[90] The Sixth Circuit took great pains in distinguishing the alleged conduct from conventional exclusive dealing as a result of United States Tobacco's role as category manager and the drastic nature of the product destruction allegations.[91]

While destruction and lying are obviously not efficiency-enhancing conduct, United States Tobacco argued that its category management program helped retailers efficiently allocate shelf space, increased consumer loyalty, and improved the presentation of products. The court dismissed these arguments out of hand. It was Conwood's burden, nonetheless, to show evidence of anticompetitive effects. So what evidence did Conwood produce to satisfy this burden? The evidence consisted primarily of expert testimony showing that a 10% increase in United States Tobacco shelf space was correlated with a 7% increase in moist snuff retail prices.[92] The court ruled that this evidence was alone sufficient to satisfy Conwood's burden and proceeded to this issue of calculating damages.[93] However, the evidence was not uncontroverted. The record also includes the following evidence: (1) Conwood's market share, and the market shares of several competitors, increased during the relevant time period;[94] (2) the market experienced a 45% increase in output;[95] (3) successful

87 253 F.3d at 70-71.

88 Andrew I. Gavil, *Exclusionary Distribution Strategies by Dominant Firms: Striking a Better Balance*, 72 ANTITRUST L.J. 3 (2004).

89 290 F.3d 768 (6th Cir. 2002). Klein & Wright, *supra* note 12, discuss *Conwood* and the economic function of category management in facilitating contract performance.

90 Klein & Wright, *supra* note 12, at 778-79.

91 *Id.*

92 *Id.* at 789.

93 The damages calculation in *Conwood* has been subject to heavy criticism for its failure to separate out the sales lost to illegal conduct from those lost to legitimate competition and other factors. *See, e.g.*. D.H. Kaye, *Adversarial Econometrics in* United States Tobacco Co. v. Conwood Co., 43 JURIMETRICS 343 (2003); D.H. Kaye, *The Dynamics of* Daubert*: Methodology, Conclusions, and Statistical Fit in Econometric Studies*, 87 VA. L. REV. 1933 (2001).

94 *Id.* at 789-90.

95 *Id.* at 789.

entry by new brands;[96] and (4) United States Tobacco enjoyed a modest 10% success rate at obtaining exclusive product display racks.[97] What is notable about the Sixth Circuit's analysis is that the liability burden was satisfied largely by anecdotal evidence of United States Tobacco's obviously bad conduct, in lieu of any serious attempt to figure out the degree of foreclosure. A reasonable hypothesis is that the conventional analysis was set aside as a result of the lack of any obvious competitive justification for the conduct at issue.

District court decisions are not immune to this trend. Consider *Avery Dennison Corp. v. Acco Brands, Inc.*[98] Avery had at least a 75% share of market for the sale of machineable labels to commercial customers in the United States. The court denied Avery's motion for summary judgment, finding that the cash payments and rebates Avery offered to customers in exchange for exclusivity were likely to be recouped through supracompetitive pricing.[99] Avery made payments of up to $2 million, and one contract included a three-year exclusivity term. The court relied heavily on Avery's own internal "hot documents" which contained predictably aggressive business propositions.[100]

The court's analysis is troublesome for a number of reasons. Like in *Conwood*, the analysis eschewed a rigorous analysis of the likely competitive effects in favor of anecdotal evidence and "hot documents."[101] Further, Avery offered significant evidence that payments for distribution were a normal part of the competitive process. In fact, it appeared that the plaintiff paid slotting fees and offered various rebates and that these payments were a competitive reality of the marketplace.[102] The court ultimately found that Avery's internal documents, success in obtaining brand loyalty, and payments for exclusivity alone were sufficient to create a triable fact as to competitive harm. It is difficult to imagine an easier standard for survival of summary judgment.

96 *Id*.

97 *Id*. at 775.

98 No. CV99-1877DT(MCX), 2000 WL 986995 (C.D. Cal. Feb. 22, 2000).

99 *Id*. at *25.

100 *Id*. at *24. One internal Avery document stated that "[w]e will use the time bought through multiyear agreements to build an Avery consumer franchise fortress. The consumer leverage we develop will allow us to renegotiate better backend deals upon termination of the multiyear deals." *Id.* at *19. Another described Avery's marketing strategy as to "go on the attack in ways that we can withdraw from if and when we are successful, so that the higher level of cost to the business has a chance of not being permanent." *Id.* On problems with the use of "hot documents" to determine whether antitrust violations have occurred, see Geoffrey A. Manne & E. Marcellus Williamson, *Hot Docs v. Cold Economics: The Use and Misuse of Business Documents in Antitrust Enforcement and Adjudication*, 47 ARIZ. L. REV. 1609 (2005).

101 The court did discuss "entrenched buyer preferences," and "Avery's ties with its commercial customers" as barriers and concluded that Acco's payment of slotting fees for placement were the result of these barriers. *Id*. at *14. Why these payments are considered barriers to entry rather than part of the competitive process for distribution is unclear and unexplained by the court.

102 Avery appeared to rely on the argument that slotting payments and rebates for exclusivity were commonplace in the market rather than asserting an affirmative business justification defense, such as a free-rider claim, explaining its use of exclusivity.

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Some debate exists as to whether the results in *Microsoft*, *Conwood*, *LePage's*, *Avery*, and other recent distribution cases constitute a disturbing trend in antitrust analysis.[103] I believe these cases, combined with the specter of Robinson-Patman prosecution, expose the failure of antitrust to articulate a workable standard for a large set of common marketing arrangements.

The analysis here provides a few immediate solutions. One simple step toward solving this problem would be to recognize the role of exclusive dealing and category management as valid business justifications minimizing dealer free-riding. Although courts occasionally recognize exclusive dealing contracts as ensuring "undivided loyalty" among dealers, this description does not adequately embrace the role of this class of contracts in facilitating contract performance.

Partial exclusion, exclusive dealing and category management provide transactors a set of tools available to control free-riding incentives created by the use of promotional payments for shelf space. Identifying the most efficient tool for the job will depend on the nature of the free-riding incentive, consumer demand for inter-brand variety and other factors. These tools allow the parties to maximize the return on the manufacturer's promotional investments and reap the fruits of their relationship by controlling the costs of dealer free-riding. Beyond these immediate solutions, Part III argues in favor of two improvements to current antitrust analysis of distribution arrangements in light of the economic analysis in Part I.

## III. Improving Antitrust Standards

The potential dangers of falsely condemning competitive conduct are well known.[104] Those error costs are exacerbated when one deals with unfamiliar forms of competition.[105] In dynamic distribution environments, the myriad of competitive tools available to manufacturers and retailers often involve novel business practices such as slotting allowances, bundled rebates, and category management. The key economic feature of these agreements is that they are components of the competitive process for distribution, which generally

103 *See, e.g.*, Elhauge, *supra* note 85; Kenneth L. Glazer & Brian R. Henry, *Coercive v. Incentivizing Conduct: A Way Out of the Section 2 Impasse?*, 18 ANTITRUST 45 (Fall 2003) ("a consensus seems to be emerging that not all is right with how cases of this kind are handled by the courts"); Brief of Amici Curiae Economics Professors in Support of Respondent at 3-4, Verizon Comm'cns Inc. v. Law Offices of Curtis V. Trinko, LLP, 538 U.S. 905 (2003) (No. 02-682) (describing the problem of identifying exclusionary conduct as "vexing"). Not all commentators find the section 2 standards so troublesome. *See* Gavil, *supra* note 88, at 51 ("There is no data to support the conclusion that Section 2 is over-deterring some kind of 'legitimate' conduct.").

104 *See, e.g.*, Verizon Comm'cns Inc. v. Law Offices of Curtis V. Trinko, LLP, 540 U.S. 398, 414 (2004).

105 One is reminded of Ronald Coase's observation that "if an economist finds something – a business practice of one sort or another – that he does not understand, he looks for a monopoly explanation." Ronald Coase, *Industrial Organization: A Proposal for Research*, *in* POLICY ISSUES AND RESEARCH OPPORTUNITIES IN INDUSTRIAL ORGANIZATION 67 (Victor R. Fuchs ed., 1972).

produces benefits to consumers in the form of lower prices, targeted price discounts, and greater amenities.

The response of antitrust doctrine to the difficult task of trading off short-run consumer benefits against potential anticompetitive consequences has been largely consistent. In *Brooke Group*, for example, the Court held that plaintiffs must satisfy a very difficult standard because above-cost discounting, which benefits consumers, "is beyond the practical ability of a judicial tribunal to control without courting intolerable risks of chilling legitimate price-cutting."[106] Judge Breyer expressed a similar judgment in *Barry Wright*, favoring existing consumer benefits over more speculative "birds in the bush."[107] This is wisely designed policy which secures the immediate short-run benefits to consumers in the absence of serious empirical evidence of anticompetitive effects. Further, the predatory pricing standard is administrable, creating a safe harbor upon which lawyers can confidently advise their clients regarding antitrust exposure.[108]

Modern distribution antitrust jurisprudence might be described as deviating from the generally accepted wisdom of the teachings of *Brooke Group* and *Barry Wright* regarding the regulation of conduct producing both obvious consumer benefits and some risk of anticompetitive harm.

### A. *Safe Harbors For Distribution Contracts*

Building on these general principles, substantial room for improvement exists within modern distribution jurisprudence. One strategy for improvement has been to propose new tests aimed at distinguishing anticompetitive business practices from those that are part of the normal competitive process.[109] A second strategy is to exploit current economic knowledge to create bright line rules of liability, therefore providing guidance to firms and their counsel.

I follow the second path, attempting to identify bright line rules from our current understanding of competition for distribution, thereby providing some certainty regarding antitrust liability for dominant firms. I am able to identify two safe harbors which are consistent with a standard attempting to identify exclusionary conduct capable of producing competitive harm by depriving rivals of efficient scale while minimizing false positives. Specifically, I argue that the following contracts should be per se legal: (1) exclusionary contracts foreclosing less than 40% of the market and (2) contracts of less than one year in duration.

106 509 U.S. at 223, 234.

107 Barry Wright Corp. v. ITT Grinnell Corp., 724 F.2d 227, 234 (1st Cir. 1983).

108 *See, e.g.*, Muris, *supra* note 75, arguing in favor of the application of the *Brooke Group* standard to bundled rebates.

109 *See, e.g.*, Aspen Skiing Co. v. Aspen Highlands Skiing Corp., 472 U.S. 585, 595-96, 605 n.32 (1985); POSNER, ANTITRUST LAW 195 (2nd ed. 2001); Elhauge, *supra* note 85; Glazer & Henry, *supra* note 103.

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1. The Case for Per Se Legality for Foreclosure less than 40%

A 40% safe harbor is largely consistent with the case law which routinely dismisses claims where foreclosure does not reach that level.[110] Though such a safe harbor will not completely eliminate the uncertainty associated with foreclosure analysis, because the degree of foreclosure will continue to vary with how broadly the distribution market is defined, it will compel consistent results for a large set of cases.

Others have made similar proposals. For example, Professor Elhauge has recently proposed a standard making distribution contracts allowing a monopolist to appropriate unexhausted scale per se legal, while all contracts foreclosing more than 50% of distribution would be per se illegal.[111] The appropriate economic question is whether the degree of foreclosure is sufficient to deprive rivals of minimum efficient scale. Because contracts that foreclose less than 40% of distribution are unlikely to deprive rivals of the ability to achieve minimum efficient scale, a safe harbor is appropriate.

A natural question is why a bright line liability rule is not equally appropriate for those contracts foreclosing greater than 50% of distribution. In short, such a rule does not appear to be based on sound economic theory or empirical evidence. The empirical justification for the rule would be evidence that economies of scale are exhausted well below 50% in the great majority of industries. I am aware of neither theoretical nor empirical support for this proposition.[112] One might also argue that competition for contract to take advantage of scale economies today might disadvantage rivals who may become more efficient in the future as a result of changes in market demand or technology.[113] However, responding to this remote threat does not require a harsh rule sacrificing efficient behavior to achieve this goal. A rule declaring short-term exclusionary contracts per se legal would solve this problem since

110 *See* Jacobson, *supra* note 27, at 324 n.85.

111 Elhauge, *supra* note 85.

112 Professor Elhauge does not rest his argument on such empirical evidence. Rather, Elhauge argues that per se illegality is appropriate because the monopolist using contracts that foreclose greater than 50% of the market, even if lowering its own costs, could have exploited those economies with less restrictive means, such as vigorous price-competition or internal expansion (vertical integration). This argument is problematic. A firm can *always* use means other than exclusionary contracts over any range of output, though it may be significantly more costly to utilize one rather than the other. The kernel of Professor Elhauge's reasoning is that it is better to allow "free market competition" to dictate firm size "rather than to allow those issues to be determined by a form of private self-regulation through discriminatory conditions." *Id.* at 325. It is unclear why competition resulting from competition for contract rather than internal expansion differs from "free market competition." Elhauge defends this proposition asserting that a *monopolist's* claim of efficiencies is analogous to the "well-accepted rejection of the natural monopoly defense." *Id.* at 326. Professor Elhauge suggests that the costs of condemning efficiency-enhancing conduct by monopolists will be outweighed by the costs of having the merit of these claims determined by "an undistorted market test" rather than distribution contracts. Hence, we return to the same notion that competition for contract is not "free market competition" and somehow "distorts" the competitive process when a monopolist is involved.

113 *See* Elhauge, *supra* note 85, at 327.

such contracts would allow a firm that achieves most-efficient status in the future to compete for distribution at asymptotically continuous intervals.

The immediate consumer benefits secured by allowing open and vigorous competition for distribution suggest that we should protect these benefits where rivals are able to bid openly for distribution, even where the competitive process results in dominant share or monopoly. Antitrust law has been equally accepting of competition for contract.[114] Mistakenly ignoring this form of competition in designing antitrust rules will result in chilling remarkable amounts of consumer welfare-enhancing activity. A 40% foreclosure safe harbor for exclusionary contracts would significantly reduce the incidence of false positives.

2. Short-Term Contract Safe Harbor

The second proposed safe harbor would immunize contracts of up to one year in duration (or longer if they are terminable at will). The duration of exclusionary contracts has long been recognized as an important factor in antitrust analysis. Contracts that successfully exclude rivals from the ability to compete for distribution for long periods of time are objectionable on the grounds that these contracts extend the duration of the monopolist's dominance while rivals seek to realign distribution contracts. Contracts of short duration are likely to allow rivals and potential entrants to compete for distribution to be delivered in the immediate future, which should be in ample supply.

There are likely to be some economic and legal objections to such a safe harbor. For instance, some might object to a one-year safe harbor on the grounds that termination of agreements with short terms, even if terminable at will, may prove difficult as a practical matter.[115] One such practical difficulty is the special case of short-term agreements with staggered expiration dates, and another is switching costs.

Where distribution contracts expire at varied dates, it may prove difficult for a rival or potential entrant to obtain distribution sufficient to support its operation at minimum efficient scale.[116] Antitrust courts have seldom evaluated

114 For example, Judge Frank Easterbrook has explained, "Competition-for-the-contract is a form of competition that antitrust laws protect rather than proscribe, and it is common." Paddock Publ'ns, Inc. v. Chicago Tribune Co., 103 F.3d 42, 45 (7th Cir. 1996).

115 At least three modern cases support this proposition. *See, e.g.*, United States v. Dentsply Int'l, Inc., 2000-1 Trade Cas. (CCH) ¶ 73,247, at ¶¶ 91,139-41 (D. Del. Mar. 30, 2001); Minnesota Mining & Mfg. Co. v. Appleton Papers, Inc., 35 F. Supp. 2d 1138, 1144 (D. Minn. 1999) ("3M has produced evidence that Appleton's sole-sourcing agreements often include incentives that have the practical effect of tying up the paper sheet inventory of a merchant over a period of several years."); United States v. Dairymen, Inc. 1983-2 Trade Cas. (CCH) ¶¶ 65,651 & 65,704 (W.D. Ky. 1983) (enjoining requirements contracts covering large percentage of the market though only 30 days to one year in duration), *aff'd per curiam*, 758 F.2d 654 (6th Cir. 1985).

116 This claim is frequently asserted in the antitrust literature. *See, e.g.*, JEAN TIROLE, THE THEORY OF INDUSTRIAL ORGANIZATION 198 (M.I.T. Press 1998) (noting that a model of a dominant firm's decision with respect to contract duration would "shed some light on the common allegation that

claims that staggered expiration dates prevent rivals from competing for distribution. In *United States v. Pullman Co.*, the court addressed Pullman's sleeping car service contracts with the railroads of the United States.[117] The court, in condemning Pullman's long term contracts (the majority lasting 15 years or longer) under the Sherman Act, noted that the staggered expiration dates increased Pullman's bargaining power in negotiating with individual railroads.[118] This is a distinct issue from whether potential sleeping car business entrants were deterred from entry because of the staggered expiration dates, though the court leaves one with the impression that it believed the staggered dates were correlated with the lack of entry into the sleeping car industry in the forty years preceding the action.[119]

Courts have infrequently dealt with staggered expiration dates in modern exclusive dealing claims. In *Amigo Gift Association v. Executive Properties, Ltd.*, for example, the court considered and rejected on the merits a trade organization's request for preliminary injunctive relief under Sherman Act sections 1 and 2 against the owner of retail space which it leased to the plaintiff's members despite the plaintiff's claims that staggered expiration dates prevented competition.[120]

The argument that staggered expiration dates prevent competition for distribution was rejected on behalf of the Seventh Circuit by Judge Easterbrook in the only case (I could find) that directly addresses the issue.[121] In *Menasha Corp. v. News America Marketing In-Store, Inc.*, both parties were sellers of at-shelf coupon dispensers sold to manufacturers for use in supermarket promotions. The defendant signed exclusive contracts with retailers in different product categories, obligating the retailer to forego the use of at-shelf coupon dispensers for competing products, and offered retailers a portion of the manufacturer's payments.[122] The plaintiff, Menasha, did not pursue such exclusive contracts.[123] Menasha argued that the staggered expiration dates of the defendant's exclusive contracts prevented Menasha from "organiz[ing] a network of retailers" to obtain "critical mass."[124] Judge Easterbrook rejected

established suppliers optimally deter entry through staggered contracts with their downstream customers. . . ."); Steven C. Salop & R. Craig Romaine, *Preserving Monopoly: Economic Analysis, Legal Standards and Microsoft*, 7 GEO. MASON L. REV. 617, 637-38 (1999) (citing the coordination problems inherent in switching retailers when expiration dates are staggered in support of the claim that "[b]idding for exclusives is not inherently 'competition on the merits'").

117 50 F. Supp. 123 (E.D. Pa. 1943).

118 *Id*. at 129 & n.8.

119 *Id*. (responding to Pullman's argument that any railroad is free to hire a competitor at the expiration of its contract by noting that "there have been no others in the field since Pullman bought out Wagner more than forty years ago").

120 588 F. Supp. 654, 656 (W.D. Mo. 1984). The court held that the plaintiff had shown neither irreparable harm nor likelihood of success on the merits. *Id*. at 660.

121 Menasha Corp. v. News America Marketing In-Store, Inc., 354 F.3d 661 (7th Cir. 2004).

122 *Id*. at 662.

123 *Id*.

124 Brief of Plaintiff-Appellant Menasha Corporation at 26-27.

Menasha's claim that staggered expiration dates prevented competition for distribution.[125]

A second, more frequently asserted proposition is that switching costs prevent termination as a practical matter.[126] Switching costs are often associated with brand loyalty-inducing effects of the manufacturer's payments. The argument raised in these cases in not compelling. The economic question is not whether costs are imposed on the dealer by switching to a rival manufacturer. Dealers certainly incur costs by terminating the contract and finding a new supplier. Not only did the dealer likely "price in" the potential future switching costs when deciding whether to accept the manufacturer's contract offer, but brand loyalty earned by the monopolist's investment is not a barrier to entry in any meaningful sense of that term.

The real antitrust issue is whether staggered expiration dates, increased consumer loyalty, or loss of payments can prevent rivals from openly competing for distribution. The answer is "no" when the contracts are of short duration. Sufficient distribution is likely to be available at any given time. The argument that a rival manufacturer cannot come up with an appealing offer to consumers is the analytical equivalent to the statement that the dominant firm has submitted a superior bid. Antitrust rules should protect the bidding process, not micro-manage the content of the bids. As long as contracts are of short duration, the competitive process for distribution is fair to both incumbents and rivals and should be left alone.

Professor Elhauge has articulated a number of other economically-oriented objections to per se legality for short-term agreements.[127] Elhauge is persuaded that collective action and seller-buyer collusion problems will "make it in [buyers'] interests not to terminate an exclusionary agreement that offers those discounts even though termination by all buyers would eliminate the anticompetitive effect."[128] I respond to each of these concerns in turn.

In the case of collusion between sellers and intermediate buyers, who in turn sell to the ultimate downstream consumer, Elhauge argues that intermediate buyers would have no incentive to terminate the agreement. The

125 354 F.3d at 663 (pointing out that Menasha does not seem to "notice the irony that under its reasoning this sign-everyone-up strategy would create an unlawful monopoly" and that "[p]erhaps Menasha should thank [the defendant] for keeping it on the straight and narrow."). Menasha's claim also lacks credibility since it apparently never offered compensation or exclusive contracts, even to those retailers with expired contracts. Non-Confidential Brief of Plaintiff-Appellant Menasha Corporation at 26-27, *Menasha*, 354 F.3d 661 (No. 03-1302).

126 In *Minnesota Mining & Mfg. Co. v. Appleton Papers, Inc.*, 35 F. Supp. 2d 1138, 1144 (D. Minn. 1999), 3M argued that a "deeply rooted customer preference" also contributed to switching costs that made leaving Appleton difficult. In *Dentsply*, 2000-1 Trade Cas. (CCH) ¶ 73,247, the Department of Justice argued that the agreements, as a practical matter, were "self-perpetuating" because dealers would not abandon the popular Dentsply brand. Plaintiff United States' Memorandum in Opposition to Defendant Dentsply's Motion for Summary Judgment at 34-35, United States v. Dentsply Int'l, Inc., (Civil Action No. 99-005(SLR)), *available at* www.usdoj.gov/atr/cases/f7000/7048.pdf.

127 Elhauge, *supra* note 85 at 340-41.

128 *Id.*

classic case of buyers agreeing to an arrangement that allows sellers to facilitate a cartel is the *Standard Oil* case.[129] Elhauge argues that *Standard Oil* exemplifies the problems with inferring that consumer welfare has increased from dealer decisions to sign exclusionary agreements. *Standard Oil*, perhaps the seminal empirical documentation of a successful strategy of raising rivals' costs, did not involve unilateral conduct that is typically the subject of section 2 monopolization claims. Rather, it involved an agreement to facilitate a horizontal price-fixing arrangement that would be per se illegal under section 1 of the Sherman Act. While horizontal collusion is certainly a problem that antitrust enforcement should be concerned with, as it always has been, I do not believe that the potential for horizontal collusion supplies any guidance for designing monopolization law.

Elhauge also argues that the logic of collective action implies that a short term contract safe harbor is inappropriate,[130] because individual buyers will not have sufficient incentive to terminate if other dealers do not do so as well. It is true that dealers facing a collective action problem might rush to join the manufacturers' cartel.[131] But this does not mean that dealers do not have the incentive to leave the cartel. Consider a monopolist's exclusionary contracts with distributors as analogous to a conspiracy among distributors organized by a dominant manufacturer. An individual distributor has more to gain by remaining outside the conspiracy and contracting with a rival manufacturer.[132] In the case of significant economies of scale in distribution (or economies of scope), an individual distributor can supply a manufacturer with minimum efficient scale. In these circumstances, a rival could defeat the exclusionary scheme by winning a single distribution contract.

Lastly, Professor Elhauge argues that to the extent terminability is relevant, it should cut against the procompetitive justifications offered for exclusionary agreements.[133] He asserts that defendants asserting that exclusionary contracts achieve efficiencies such as providing certainty in supply, or encouraging relation-specific investments, or otherwise increase efficiency are likely pretextual if buyers can terminate whenever they like.[134]

This analysis ignores the role of exclusionary contracts minimizing dealer free-riding incentives.[135] The short-run gain to a dealer from violating its

129 Standard Oil Co. of New Jersey v. United States, 221 U.S. 1 (1911). *See* Elizabeth Granitz & Benjamin Klein, *Monopolization by "Raising Rivals' Costs": The* Standard Oil *Case*, 39 J.L. & ECON. 1 (1996).

130 *See* Elhauge, *supra* note 85, at 340.

131 The original exposition of this point was made in Eric Rasmusen et al., *Naked Exclusion*, 81 AM. ECON. REV. 1137 (1991); *see also* Ilya R. Segal & Michael D. Whinston, *Naked Exclusion: Comment*, 90 AM. ECON. REV. 296 (2000).

132 This is not unusual. It is analytically identical to the familiar incentive to cheat on a horizontal collusive agreement by expanding sales.

133 *See* Elhauge, *supra* note 85, at 341.

134 *See id.*

135 *See supra* Part I.

performance obligations under the agreement is always positive since manufacturers do not always instantaneously detect nonperformance. Similarly, agreements that are terminable at will also decrease the dealer's potential for short-term gains appropriated by violating the parties' understanding.

However, the issue in antitrust cases is typically the role of the dealer's right to terminate. The economic reasoning is analytically identical: allowing the dealer to terminate at will reduces the manufacturer's incentive to violate the implicit understanding of the parties' distribution arrangement since his gains from doing so will be limited to only one period. The manufacturer's performance obligation might be to supply a quality product, to supply it on time, or any other form of performance that the parties mutually understand. For example, consider the role of dealer termination in a category management relationship wherein the manufacturer's performance obligation is to supply sound advice regarding product allocation decisions and to supply sufficient product variety to satisfy consumer demand.[136] In order to facilitate efficient self-enforcement of these performance obligations, the dealer's right to terminate at will is an essential part of the arrangement.

Finally, there is also a legal objection to the short-term contract safe harbor. Specifically, the safe harbor conflicts on some level with Supreme Court authority invalidating a number of exclusionary agreements that were of short duration and terminable on short notice.[137] The issue of presumptive legality of short-term exclusionary contracts is still open to some debate in the lower courts as well.[138] However, the majority of courts appear to adopt the view that short-term exclusionary contracts are not likely to deprive rivals of distribution.[139]

136 *See* Klein & Wright, *supra* note 12.

137 *See, e.g.*, Standard Fashion Co. v. Magrane-Houston Co., 258 U.S. 346, 352 (1922) (invalidating agreements that were terminable upon three months notice); Standard Oil Co. of New Jersey v. United States, 221 U.S. 1 (1911).

138 See cases cited in note 115. In addition, the district court denied Coca-Cola's motion to dismiss claiming that its distribution agreements were per se lawful because they were terminable at will upon ten days' notice. Jacobson, *supra* note 27, at 337 (discussing this motion). The district court later granted Coca-Cola's motion for summary judgment on the grounds that Coke did not have market power in the relevant market. PepsiCo., Inc. v. Coca-Cola Co., 114 F. Supp. 2d 243 (S.D.N.Y 2000), *aff'd per curiam*, 315 F.3d 101, 111 (2d Cir. 2002) (affirming the district court's market power findings while briefly noting that Coca-Cola's exclusive distributorships are short in duration and terminable at will).

139 Most recently, the First, Second, Fourth, Seventh and Ninth Circuits have embraced the notion that contracts terminable in less than one year are either presumptively legal or most likely are unable to foreclose rivals. *See* CDC Technologies., Inc. v. IDEXX Labs, Inc., 186 F.3d 74 (2d Cir. 1999); Omega Envtl., Inc. v. Gilbarco, Inc., 127 F.3d 1157, 1163 (9th Cir. 1997) ("short duration and easy terminability of these agreements negate substantially their potential to foreclose competition"); Paddock Publ'ns, Inc. v. Chicago Tribune Co., 103 F.3d 42, 47 (7th Cir. 1996) ("the FTC and the Supreme Court concluded that even exclusive dealing contracts are lawful if limited to one year's duration"); Thompson Everett, Inc. v. Nat'l Cable Adver., 57 F.3d 1317, 1325 (4th Cir. 1995); U.S. Healthcare, Inc. v. Healthsource, Inc., 986 F.2d 589, 596 (1st Cir. 1993); Roland Mach. Co. v. Dresser Indus., Inc., 749 F.2d 380, 395 (7th Cir. 1984).

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The argument that Supreme Court precedent prohibits such a safe harbor is not without force. "Old" case law that is largely ignored in modern antitrust analysis has been part of the antitrust policy landscape, for better or worse, for many years.[140] A strict interpretation of Supreme Court precedent would render at least the modern law of horizontal merger, vertical integration, exclusive dealing, and tying useless.[141] This would be an absurd result that should be avoided if it at all possible. Admittedly, designing modern antitrust policy in a manner that ignores the precedential value of traditionally disregarded "old" case law is certainly not ideal. Modern common law has evolved in just this fashion. The first-best solution is clearly to take weak and outdated precedent off the books rather than design antitrust laws around obsolete economic and legal thought regarding exclusionary contracts. Short of that, I believe that the short duration contract safe harbor consistent with both modern exclusive dealing case law and economic theory.

### B. *Application to Recent Exclusionary Distribution Cases*

This Part addresses what impact these two proposed safe harbors would have on important exclusionary distribution cases by applying the standard to the following nine appellate decisions: *Microsoft*, *LePage's*, *Conwood*, *Concord Boat*,[142] *Virgin Atlantic*,[143] *RJR II*, *Coca-Cola*, *Omega*, and *Dentsply*.[144] A complete analysis of the conduct at issue in each specific case is beyond the scope of this article.

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140 Horizontal merger decisions prior to *General Dynamics* are a very good example of "old" case law that no longer influences modern antitrust policy. I have advocated overturning these outdated and weak precedents due to the risks that they might influence modern antitrust policy through private actions or otherwise. Wright, *supra* note 34, at 746-47. An excellent example in the vertical merger context is *Ford Motor Co. v. United States*, 405 U.S. 562 (1972), which invalidated Ford's purchase of Electric Autolite, a sparkplug manufacturer, on the basis that the merger would harm competition because rival sparkplug manufacturers would be foreclosed from sales to Ford (10% of the market). There are, of course, many other excellent examples.

141 Professor Elhauge also argues that because all contracts that are unreasonable restraints of trade are not enforceable at common law, the contracts have always been terminable at will. Combining this insight with the fact that antitrust liability still lies for agreements in restraint of trade in the face of terminability at will, Professor Elhauge concludes that terminability at will has no place in determining antitrust liability. He argues that the assertion that terminability at will can immunize conduct from antitrust liability would thus render horizontal price-fixing agreements per se legal. *See* Elhauge, *supra* note 85, at 342. This is incorrect. The point of the safe harbor is not one of mere formality, but economic substance. The safe harbor protects such agreements that are terminable at will because, as a matter of economics, they cannot result in anticompetitive harm. Compare this to a horizontal price-fixing agreement, which can reduce social welfare whether the agreement is terminable at will or of long duration. This substantive difference provides the rationale for creating immunity for conduct that cannot produce anticompetitive effects. I disagree with Professor Elhauge that the necessary implication of this distinction is to "take Sherman Act § 1 and Clayton Act § 3 off the books, as well as any application of Sherman Act § 2 to exclusionary conduct that requires buyer acquiescence." *Id*.

142 Concord Boat Corp. v. Brunswick Corp., 207 F.3d 1039 (8th Cir. 2000).

143 Virgin Atl. Airways Ltd. v. British Airways PLC, 257 F.3d 256 (2d Cir. 2001).

144 United States v. Dentsply Int'l, Inc., No. 03-4097, 2005 WL 426818 at *1 (3d Cir. Feb. 24 2005).

The short-term safe harbor would change only the outcome of *Dentsply*, where the Third Circuit recently overturned the district court's judgment in favor of the defendant.[145] There, the fact that the agreements were terminable at will would immunize the manufacturer from liability on the grounds that competition for Dentsply dealers and others, was feasible on short intervals.[146] Though *Omega*, *Coca-Cola*, *Concord Boat*[147] and *RJR II* would also fall under the safe harbor, this would not change the ultimate result in those cases.

Interestingly, the foreclosure safe harbor may have provided Microsoft immunity under section 2 from challenges to its exclusive dealing contracts with Internet access providers. The District Court conceded that the plaintiff failed to produce evidence that "Microsoft's agreements excluded Netscape altogether from access to [at least] forty percent of the browser market"[148] but held that Microsoft's arrangements gave rise to section 2 liability because they excluded Netscape from the most efficient means of distribution. The D.C. Circuit upheld the District Court's section 2 analysis.[149] Some may object that this safe harbor would immunize agreements likely to cause anticompetitive harm. However, the evidence of actual anticompetitive effect in *Microsoft*, is not overwhelming and it should be emphasized that barriers to entry cannot be increased without sufficient foreclosure. One of the key insights of the economics of competition for distribution is that payments are passed on to consumers and should be balanced alongside any anticompetitive potential in designing antitrust rules. Microsoft's distribution contracts, for example, resulted in the zero pricing of Internet Explorer and large promotional payments to Internet access providers, both producing significant benefits for consumers.

The remaining two cases are perhaps the most difficult to analyze: *Conwood* and *LePage's*. Because both defendants conceded their market power,[150] and neither was able to persuade the jury that its proffered business

145 *See id.* at *1 (reversing judgment for manufacturer on the grounds that plaintiff did not successfully prove the existence of monopoly power and its use to exclude rivals).

146 This was the crux of the district court's rejection of the Department of Justice's claim that the contracts were anticompetitive. *See* United States v. Dentsply Int'l Inc., 277 F. Supp. 2d 387, 453 (D. Del. 2003) ("[D]irect distribution is viable, non-*Dentsply* dealers are available, and *Dentsply* dealers may be converted at any time.").

147 207 F.3d at 1059. Most agreements were of one year duration and terminable at any time, though an additional 1-2% were available for commitments of two to three years. *Id.* at 1059-60.

148 United States v. Microsoft Corp., 87 F. Supp. 2d 30, 52 (D.D.C. 2000), *aff'd in part, rev'd in part*, 253 F.3d 34 (D.C. Cir. 2001), *cert. denied*, 122 S. Ct. 350 (2001). Though the district court does not show its work in coming to a foreclosure share of less than 40%, Benjamin Klein has estimated the percentage to be approximately 38% of total distribution based on the fact that the exclusives covered approximately 55% of distribution, since 25% of users obtained their browsers directly from Internet access providers and another 20% of users from the purchase of their home computer. Incorporating the fact that Microsoft's exclusive contracts typically required Internet access providers to obtain a maximum of 85% Internet Explorer usage, these facts would result in a foreclosure share of less than 40% (0.45 x 0.85 = 38%). Klein, *supra* note 11, at 127 n.23.

149 253 F.3d 34, 64 (D.C. Cir. 2001).

150 *See* LePage's Inc. v. 3M, 324 F.3d 141, 146 (3d. Cir. 2003), *cert. denied*, 124 S. Ct. 2932 (2004); Conwood Co. v. United States Tobacco Co., 290 F.3d 768, 782 (6th Cir. 2002).

justification was valid,[151] both cases turned on the plaintiff's prima facie evidence that the conduct was anticompetitive.

First, consider the impact of the 40% foreclosure safe harbor. It is unclear whether the level of foreclosure created by the combination of United States Tobacco's exclusive racks and destruction of Conwood's display racks would have deprived Conwood of access to more than 40% of display racks.[152] From the evidence in the record, it is unlikely that United States Tobacco's conduct foreclosed 40% of display racks. To the contrary, United States Tobacco was only able to obtain exclusive racks in 10% of retail stores, suggesting robust competition for distribution and ample availability for rivals.

*LePage's* is also unclear on this point, in large part due to the paucity of the record. The debate as to whether above-cost multi-product bundled discounts should be treated as exclusive dealing, tying, or predatory pricing is unresolved and likely to continue for some time.[153] 3M's two exclusive dealing contracts were ruled immaterial to the disposition of *LePage's*.[154] LePage's did not claim that 3M's promotional payments amounted to below-cost pricing,[155] opting instead to argue that 3M's discounts deprived it of "efficiencies of scale" in the tape manufacturing business.[156] Would 3M's bundled rebates foreclose rivals from more than 40% of the market for distribution? Again, I am skeptical.

The critical antitrust question is whether the competitive process for distribution was open to LePage's to engage in competitive bidding, and it appears that it was. LePage's offered its own price discounts to large customers such as Wal-Mart, K-Mart, Staples, Office Max, and Walgreens.[157] The size of these retailers suggests the presence of significant economies of scale in

151 *See LePage's*, 324 F.3d at 163-64; *Conwood*, 290 F.3d at 787 n.4 (rejecting defendant's assertion that its conduct increased consumer loyalty and improved product presentation).

152 Conwood presented evidence that product destruction amounted to costs of $100,000 per month. *Conwood*, 290 F.3d at 778. This analysis assumes that the short-term contract safe harbor would not immunize United States Tobacco because Conwood's allegations included some forms of non-contractual conduct.

153 *See* Crane, *supra* note 75; Gavil, *supra* note 88, at 34; Glazer & Henry, *supra* note 103, at 45; Nalebuff, Portfolio Effects, *supra* note 74 (arguing that an *Ortho* predatory pricing standard is appropriate); Greenlee et al., *supra* note 75 (advocating a tying approach); Ronald W. Davis, LePage's v. 3M*: Five Ingredients in Search of a Monopoly Broth*, ANTITRUST SOURCE (November 2004), http://www.abanet.org/antitrust/source/11-04/Nov04-Davis1129.pdf; David L. Meyer, LePage's II: *The Third Circuit Revisits 3M's Bundled Discounts and Sees Unlawful "Exclusion" Instead of Above-Cost Pricing*, ANTITRUST SOURCE (July 2003), http://www.abanet.org/antitrust/source/07-03/meyer.pdf; Muris, *supra* note 75 (arguing in favor of the *Brooke Group* standard).

154 *LePage's*, 324 F.3d at 157.

155 They could not have done so successfully since there was no evidence that 3M priced below any relevant measure of cost even if one allocated all discounts in the product line to transparent tape.

156 *LePage's*, 324 F.3d at 154-55.

157 *Id*. at 171-73 (Greenberg, J., dissenting). The Solicitor General's amicus brief notes that the "Third Circuit did not say there was sufficient evidence for the jury to conclude that LePage's could not have made comparable offers" to 3M customers. Brief for the United States as Amicus Curiae for Respondents at 6, LePage's Inc. v. 3M, 324 F.3d 141 (No. 02-1865).

distribution, which, if large enough to support a manufacturer of efficient scale, would allow LePage's to achieve minimum efficient scale by winning a single distribution contract. Therefore, while the record is not sufficient to calculate the degree of foreclosure resulting from 3M's bundled rebate programs, the evidence suggests that the contracts were not capable of depriving LePage's of minimum efficient scale and therefore may have been immunized under the foreclosure safe harbor.

## IV. Conclusion

The increasing importance of manufacturer payments for distribution, category management, and exclusive dealing suggests a dynamic environment which will continue to present challenges for antitrust authorities. This world of competition for distribution necessarily involves competition-for-contract, where consumer benefits flow to consumers indirectly through payments to distributors. Designing antitrust rules to govern the competitive process for distribution is a challenging and important task, and some commentators believe antitrust is failing.[158]

The economic insights collected in this paper show that manufacturer payments and exclusionary distribution terms are frequently related phenomena, the former increasing highly profitable promotional sales and the latter minimizing dealer free-riding incentives created by those payments. Competition for distribution results in the use of a variety of efficiency enhancing contractual mechanisms. A key feature of these promotional contracts, regardless of form, is that they produce significant benefits for consumers.

Three significant policy implications are implicated by this analysis. First, antitrust law should broaden its search for efficiency justifications to include the pro-competitive role of promotional contracts in solving a pervasive incentive incompatibility problem and the use of exclusionary terms and category management in minimizing the retailer free-riding on the manufacturer's compensation mechanism. Second, antitrust law should respect the wisdom of *Brooke Group* and *Barry Wright*, which teach that short-run benefits should not be sacrificed to protect against future harm without convincing theoretical and empirical evidence of anticompetitive effects. Third, a greater understanding of the economics of competition for distribution alone will not provide much needed bright-line guidance to firms with dominant market shares. The introduction of important safe harbors for promotional contracts foreclosing less than 40% of distribution and for those shorter than

158 *See* David Balto, *Ten Developments in the Antitrust Treatment of Category Management and Slotting Allowances*, ANTITRUST REP., Spr. 2004, at 103, 135 (commenting that "few areas are as unsettled or need a foundation of clear guidance").

one year in duration would significantly reduce false positives, providing certainty without significant offsetting risks of competitive harm.