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THE ANTITRUST LAW AND ECONOMICS OF CATEGORY MANAGEMENT

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Abstract

Category management is a business technique by which a retailer designates a manufacturer as a product category "manager" or "captain" and gives the designated manufacturer authority concerning retail shelf space allocation, promotion and product assortment inventory decisions. In return, the retailer receives a lower wholesale price or a per unit time payment. Increasing antitrust scrutiny has been applied to category manager arrangements, as exemplified by the Sixth Circuit's recent decision in *Conwood Co. v. United States Tobacco. Co*. This paper analyzes the law and economics of such arrangements. Manufacturer payments for retail distribution (shelf space) are shown to be an element of the normal competitive process. Why this competition for retail distribution may also result in a shift in control over the shelf space allocation decision from the retailer to a manufacturer is then analyzed. Finally, the paper examines current antitrust policy with regard to category management. Once we understand the economics of competition for retail distribution, category management is seen as a pro-competitive aspect of retailing arrangements that benefits consumers.

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1. Introduction

Category management is a business technique by which retailers make decisions concerning shelf space allocation, promotion, and inventory by product category.[1] Typically, category management involves a retailer designating a particular manufacturer as "category captain" or "category manager." The role of the category manager is to provide input to the retailer regarding shelf space allocation decisions and product assortment. Category management has been gaining popularity and has been adopted by an increasing number of retailers.[2] A recent study showed that 78% of department stores, 74% of discount stores, and 45% of supermarkets deploy category management.[3]

Recently, the Federal Trade Commission's Report on slotting allowances and other grocery marketing practices included a discussion of category management. The FTC Report states that "category management can produce

[1] Category management has been employed in several retail trades for years, but is relatively new to the grocery retail industry. FTC Report on Slotting Allowances and Grocery Marketing Practices (FTC Report), at 47. Throughout the paper, the terms "retailer" and "distributor" are used interchangeably and will refer to product distribution generally.

[2] Progressive Grocer (December 1993).

[3] Chain Store Age (March 2000). For example, it was reported that Borders Group, Inc. intended to move to category management relationships with a number of book publishers. Reportedly, Borders will choose publishers to manage or co-manage over 250 categories in the store. Captains will assist Borders in the selecting which book titles will be carried and how the books will be displayed. Borders is expected to retain the final say over which books are purchased. Publishers are thought to have superior knowledge on issues such as which books sell better together, which might sell better with book jackets facing outward, and how books should be located in the stores and on shelves. It is reported that publishers may pay up to $110,000 annually for the right to become a category manager. See Wall Street Journal, Is Selling Books Like Selling Frozen Food, May 20, 2002.

significant efficiencies that will benefit retailers, manufacturers and consumers."[4] However, the FTC Report also listed two primary competitive concerns with the practice. One of these concerns is horizontal collusion between either manufacturers or retailers.[5] The second concern is that the captain may use its position to effectively exclude or significantly disadvantage competitors, exposing consumers to the risk of decreased product variety or increased prices.[6] The antitrust issues regarding horizontal collusion are adequately handled by the price-fixing provisions in the Sherman Act and are outside the scope of this paper, which deals with the second concern.

The importance of a manufacturer's "category captain" status has played a role in recent antitrust litigation. In *Conwood Co. v. United States Tobacco Co.*, the United States Tobacco Co.'s (USTC) was found to have abused its position as

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[4] FTC Report at 54.

[5] Id. at 51-52. Colluding retailers may wish to coerce, or otherwise enlist, the category manager to facilitate the cartel. Assuming it controls a sufficient share of the product market, the captain may administer the cartel by fixing a uniform retail price and allocating sales to the members of the cartel. See Elizabeth Granitz & Benjamin Klein, *Monopolization by "Raising Rivals' Costs": The Standard Oil Case*, 39 J.L. & ECON. 1 (1996). The FTC Report stresses the possibility of a tacit agreement amongst retailers facilitated by a captain that makes identical recommendations to all of the retailers and provides a common point of reference for pricing, promotion and product placement decisions of rivals. FTC Report at 51. Similarly, category management may potentially facilitate a manufacturer cartel. Colluding manufacturers may wish to fix the retail price rather than the wholesale price in order to lower the costs of detecting cheating. The FTC Report raises the concern that leading manufacturers could "confer and agree on a category management recommendation." FTC Report at 53. Each of these arrangements requires a horizontal agreement between retailers or manufacturers that is vulnerable to legal attack by traditional Sherman Act Section 1 conspiracy doctrine.

[6] FTC Report at 51.

category captain to violate Section 2 of the Sherman Act.[7] The court stated that "Conwood does not challenge USTC's role as category manager per se, but rather the manner in which it used its position as a monopolist providing category management services, i.e. to exclude it from competition" and affirmed a $1.05 billion verdict against USTC.[8] The decision highlights general issues of antitrust policy with respect to the competitive process for distribution of products and raises specific issues concerning what additional legal constraints the Sherman Act imposes on dominant firms that have been designated as category manager.

The fundamental economic question addressed by this paper is: "why would a retailer shift control over the shelf space allocation decision to a manufacturer?" A proper answer to that question requires an understanding of the economic forces at work in distribution contracts involving retailer promotional efforts generally, and retailer supply of shelf space more specifically. Only then can a useful framework for analyzing promotional contracts between manufacturers and retailers be derived along with a critique of current antitrust policy with respect to category management practices, exemplified by the misleading analysis in *Conwood*.

[7] Conwood Co. v. United States Tobacco Co., 290 F.3d 768 (6th Cir. 2002).

[8] 290 F.3d at 786-87.

Manufacturers often purchase retailer promotional efforts, with shelf space considered in this paper a form of retailer promotional efforts. For example, a retailer may grant the manufacturer a specified percentage of shelf space or an exclusive contract over the shelf space, or designate the manufacturer as category manager. Manufacturers may compensate retailers for such shelf space in a number of ways that fall into two general categories: (1) per unit time payments, such as slotting fees; and (2) per unit sale payments, such as a discounted wholesale price, often used in conjunction with resale price maintenance (RPM).

While shelf space may not be considered intuitively equivalent to other forms of retailer promotional effort, such as the time a salesperson spends with a customer, or in-store advertising displays,[9] shelf space performs an identical economic function. Provision of eye-level shelf space or a large percentage of retailer shelf space allocated to a particular product may increase the value of the product to some consumers. Promotion serves the function of increasing the reservation values of particular consumers. The provision of quantitatively or qualitatively superior shelf space may also increase the reservation values of particular consumers, especially those without a strong brand preference that

[9] The promotional impact of shelf space concerns the supply of shelf space for one product in a category relative to another. The aggregate amount of shelf space remains the same when a retailer promotes a product within a category. Other forms of retailer promotional effort are intuitively different because there may be insufficient aggregate amount of other forms.

might be especially sensitive to a retailer featuring a particular brand on its shelves.

Section 2 considers the role of retailer shelf space as a form of promotion and the contracting environment facing manufacturers and retailers in providing the correct amount of shelf space. The conditions under which it might be efficient for manufacturers to purchase shelf space from retailers is addressed. Section 3 examines the retailer's incentive to violate the contract for the supply of shelf space by promoting rival products, and the costs and benefits of using exclusivity as a method of controlling this incentive. Section 4 shows how category manager contracts facilitate self-enforcement by optimally shifting the potential for nonperformance from the retailer to the manufacturer. In this way retailers may be able to obtain the best of both worlds by receiving manufacturer payments under conditions where it is not economical to provide an exclusive right to shelf space because consumers demand increased variety. Section 5 discusses the antitrust law and economics of category management contracts, including an analysis of when exclusionary distribution contracts may be anticompetitive. The *Conwood* decision is then examined through the lens of these economic insights.

2. Why Manufacturers Purchase Retail Shelf Space

Promotional activity is a way to induce sales that would not occur otherwise. These incremental sales are made to "marginal consumers," defined as consumers who would not otherwise purchase the product, or as additional sales to existing consumers. A retailer, for example, may provide a dedicated sales staff which will explain the virtues of a particular product, provide demonstrations, or otherwise convince a particular consumer to purchase this particular manufacturer's product. These promotional services are supplied at a zero price as a way to provide an effective price discount to marginal consumers by increasing the reservation values of "marginal" buyers who would not otherwise purchase the product at the market price. Marginal consumers generally consume a relatively large fraction of these promotional services because "infra-marginal" consumers, those with a strong brand preference or who are otherwise already purchasing the product, are likely to avoid the time costs involved in consuming the promotion.

An assumption underlying the analysis of manufacturer purchase of retailer shelf space is that the provision of shelf space affects the reservation values of some marginal consumers.[10] The analysis of the shelf space allocation problem in this paper relies on the economic function of shelf space as retailer

[10] This assumption has some empirical support. *See* Adam Rennhoff, A Theoretical and Empirical Investigation of Slotting Allowances in the Grocery Industry (2002).

promotional activity. Shelf space differs from the provision of product demonstration and salesperson attention in some fundamental respects. For example, shelf space is a public-type good in the sense that retailer shelf space allocation featuring a particular product is not consumed by any one shopper at the expense of another. However, so is advertising, which is a manufacturer-supplied substitute for shelf space. This practical distinction is irrelevant for the purposes of the economic analysis contained herein. While marginal consumers cannot be said to consume a relatively large fraction of the shelf space, there exist consumers that are particularly sensitive to shelf space allocation. Therefore, the goal of the provision of a large quantity or superior quality of shelf space is therefore to increase the reservation value of the shelf-space-sensitive consumer to the prevailing market price.

In general, distributors will not provide the desired level of shelf space from the manufacturer's point of view because distributors will not take account of the incremental manufacturer profit when making their shelf space decisions. The manufacturer earns a mark-up above marginal cost on each unit because it faces a downward sloping demand curve for its product. Thus, joint profits increase from the provision of shelf space if the manufacturer mark-up exceeds the marginal cost of providing the level of services that induce the purchase of an additional unit. Because the retailer does not take into account the effect of his

provision of promotional services on the manufacturer's profits when deciding what level of promotional service to provide, the retailer must be compensated for the provision of these services.[11]

It follows from this proposition that additional retailer provision of a high quantity or superior quality of shelf space will be particularly important when the manufacturer is selling a product with a wholesale price significantly higher than marginal cost.[12] However, even where a manufacturer stands to gain substantially from incremental sales, the retailer will not provide the additional shelf space if the costs of providing those services are greater than the revenues it earns as a result of the promotion.

In general, if all consumers value the shelf space more than the costs of providing the shelf space, distributor competition would result in the desired level of shelf space by simply charging higher prices to consumers. However, the provision of "extra" shelf space is a way to generate incremental sales by

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[11] Benjamin Klein, The Economics of Slotting Fees, American Bar Association – Antitrust Section (2001).

[12] It is generally reported that the magnitude and frequency of slotting allowances, or per unit time payments from manufacturers to retailers for the provision of shelf space, has increased in recent years. FTC Report, at 11. Increased product differentiation and mark-ups in products sold in grocery retail outlets is consistent with this empirical observation. Measures of manufacturer "value-added," defined as the difference between costs of production and the value of shipments, has increased 23% from 1992 to 1997. See Michael J. Harris, Food Manufacturing in U.S. Food Marketing System 2002 (USDA Economic Research Service). This increase in product differentiation expenditures implies higher manufacturer margins, and increasing gains to be had from retailer promotional effort, such as provision of shelf space.

providing "infra-marginal" consumers who in fact are not willing to pay for the services in the form of a higher price an effective price discount. The provision of shelf space is therefore analogous to promotional activity giving an effective price discount to marginal consumers whose reservation values for a particular product are sensitive to shelf space allocation.

Since in many distribution relationships manufacturers desire retailers to supply a greater level of promotion than they would otherwise provide, the payments will flow from the manufacturer to the distributor. Whether the payments are per unit time (e.g., a slotting fee) or per unit sale (a wholesale price discount), the payments are compensation of distributors for increasing the level of shelf space supplied.

The manufacturer compensation side of the distribution contract may be viewed as a method for manufacturers to secure promotional effort. This promotional theory of vertical contractual relationships, discussed by Klein & Murphy, suggests that the manufacturers cannot rely on the retailer to provide the correct level of promotional effort.[13] This broadly applicable theory is developed here in the context of contracts over the provision of a particular type of retailer promotional service – shelf space.

[13] Benjamin Klein & Kevin Murphy, Vertical Restraints as Contract Enforcement Mechanisms, 31 J.L. & ECON. 265 (1988).

In some cases, consumers may value the provision of retailer shelf space more than the costs of providing the services. If this condition holds, retail competition would provide the correct level of shelf space because the retailer may be compensated for the provision of shelf space through a higher retail price. Therefore, a key economic assumption underlying the analysis of manufacturer compensation for retailer provision of shelf space is that consumers are not willing to pay for the provision of those services. As discussed above, "marginal" consumers are likely to be more sensitive to shelf space allocation than "infra-marginal" consumers with less responsiveness to shelf space allocation due to strong brand preference, for example. Because infra-marginal consumers do not value the extra shelf space provided by the retailer, the retailer cannot be compensated for the provision of the services by charging a higher retail price. Therefore, the provision of extra shelf space raises the reservation values of some marginal consumers to the market price, thereby giving those consumers what can be thought of as an effective price discount.

The manufacturer is able to increase his level of sales by effectively lowering the price to, which can also be conceptualized as raising the reservation value of, those consumers who are highly sensitive to the provision of these services and charging a higher price to those consumers who are not. Because of this distortion, manufacturers must compensate retailers for the provision of

shelf space. Regardless of the form manufacturers use to compensate retailers, the manufacturer-retailer combination will be unable to achieve the jointly profit-maximizing outcome without manufacturer purchase of shelf space.[14]

3. Exclusivity Facilitates Self-Enforcement of the Retailer Promotion Supply Contract

As shown, manufacturer compensation of retailers for the provision of shelf space is necessary under certain conditions. However, retailers receiving this premium for the supply of shelf space have the incentive to substitute their promotional efforts towards rival products. Exclusive dealing contracts are one method by which manufacturers can control the retailer incentive to substitute the supply of promotional effort to rival products by facilitating performance of the contract. Understanding how exclusivity facilitates performance of the contract and control's the retailer's incentives is important to understanding the related mechanism of "category captain" designation functions.

[14] This motivation for vertical restraints is not the "classic dealer free riding" discussed by Lester Telser where the restraint prevents "discount" retailers from free-riding on the services provided by a particular retailer after the retailer has supplied the services. See Lester Telser, Why Should Manufacturers Want Fair Trade?, 3 J.L. & ECON. 86 (1960). This rationale for vertical restraints prevents retail competition from undermining the compensation mechanism chosen by manufacturers and retailers to reach the jointly profit-maximizing choice of price, output and promotional services. See generally, Klein & Murphy, *supra* note 13.

3.1. Retailers Have an Incentive to Violate the Contract by Substituting Promotional Effort Towards Rival Products

The incentive to promote the sale of rival products follows from the nature of promotional activity. As discussed, promotional effort such as the provision of shelf space is aimed at creating incremental sales from those who would not have otherwise purchased the product but are particularly sensitive to shelf-space allocation. Recall that the marginal consumers, those with reservation values lower than the market price and with sensitivity to shelf space allocation, are not likely to have any strong brand preference. Therefore, marginal consumers are likely to be willing to purchase a rival, low brand-name product in response to a retailer's promotional efforts. A low brand-name product may produce a higher margin for the retailer because it purchases the product at a wholesale price much closer to marginal cost than the differentiated, high mark-up product paying for promotion.[15] Even if the rival product is sold at the same wholesale price as the product paying for shelf space, the retailer might have the incentive to promote the rival product if the costs of promoting that product are lower.

For example, a customer asking for a rival, equal-margined, brand might not be greeted with promotion of the manufacturer's product because the costs

[15] See Benjamin Klein, Exclusive Dealing as Competition for Distribution "On the Merits," GMULR (forthcoming 2004), at 43.

of promotion will reduce the retailer's profit margin. In the shelf space context, provision of promotional effort is limited to allocating shelf space in the manner required by contract. A retailer may choose not to "feature" the manufacturer's brand by providing the quantitative and qualitative level of shelf space specified, and instead, feature a low-brand name rival product providing the retailer a higher profit margin. A retailer may also choose not to provide the manufacturer's desired level of shelf space if it perceives that many consumers are coming to the shelves searching for a rival product because the costs of providing the "featured" shelf space may provide a lower margin for the retailer than choosing not to promote the manufacturer's product.

In essence, a retailer has the incentive to deviate from the shelf-space agreement by accepting the manufacturer's payments and not performing by selling its promotional efforts twice or failing to provide the correct level of shelf space. Specifically, a retailer sells its "featured" shelf space to the manufacturer in exchange for payments and does not provide that shelf space to the retailer or features a rival product.

3.2. Exclusivity Permits Manufacturers to Control the Retailer Incentive to Violate the Contract by Promoting Rival Products

Unless the manufacturer can control the distributor incentive to promote rival products, a manufacturer will not continue to provide payments for

promotional effort, and the joint-profit maximizing outcome will not be reached. Exclusive dealing, then, is a way for manufacturers to control the ability of distributors to substitute away towards rival products and increases the probability that a manufacturer receives the promotional effort it has purchased from the distributor.

A manufacturer must monitor the retailer to assure that it is receiving the level of promotional effort contractually specified, as well as monitor the exclusive and non-contractible elements of the agreement. One efficiency benefit of exclusivity is that the requirement lowers the monitoring costs of the manufacturer who need only be certain that the retailer is not selling other products. Exclusive dealing therefore reduces the distributor incentive to free-ride on the manufacturer's compensation mechanism and therefore facilitates an efficient solution to the incentive incompatibility of the manufacturer and distributor with respect to the provision of promotional effort.

By contractually controlling retailer non-performance, it increases the probability that given a level of manufacturer monitoring costs and compensation for promotion, the contractual understanding is self-enforcing. By preventing dealers from using their shelf space and promotional effort from promoting rival brands, exclusive dealing allows retailers to receive the benefit of the premium stream paid by manufacturers over a greater period of time, and

the value of retailer promotion purchased by the manufacturer increases.[16] Further, exclusive dealing facilitates self-enforcement by shifting the ability to non-perform from the retailer to the manufacturer as well as decreasing monitoring costs. The self-enforcement mechanisms at work will be discussed further in Section 4.

3.3. Self-Enforcing Contractual Arrangements[17]

The incomplete contracts literature has provided valuable insight into understanding the interplay between institutional settings, contracting

[16] Increased promotional activity for the manufacturer's product by reducing the ability to promote rivals has been accepted as an efficiency rationale for exclusive dealing in Joyce Beverages v. Royal Crown Cola Co., 555 F. Supp. 271 (S.D.N.Y. 1983), and Hendricks Music Co. v. Steinway, Inc., 689 F. Supp. 1501, 1545 (N.D. Ill. 1988) ("Steinway argues that the existence in one dealership of two competing [concert and artist] programs creates a conflict of interests and that it is therefore justified in its insistence that dealers represent the Steinway [concert and artist] program exclusively . . .. The court finds Steinway's position more persuasive."). See also Fran Welch Real Estate Sales, Inc. v. Seabrook Island Co., 621 F. Supp. 128, 138 (S.C. 1985) (holding that "there are valid and procompetitive business reasons for exclusive listing agreements. Such agreements . . . benefit both the real estate agent and the property seller, protecting the agent from the risk of a wasted investment of time and money and providing the property seller with assurance that the agent will utilize his or her best efforts to market the property."). Whether or not this efficiency rationale is well-accepted is a debatable proposition. While few district court cases have addressed the issue and supported the "focus dealer services" or "dedicated distributor" rationale for exclusive dealing, a recent antitrust decision explicitly rejects this rationale. See United States v. Dentsply Int'l, Inc., No. 99-005-SLR, 2003 U.S. Dist. LEXIS 14139, 153 (D. Del. Aug. 9, 2003). Benjamin Klein notes that the Dentsply court rejected this rationale in part because Dentsply's economic expert was Howard Marvel, whose 1982 paper states that enhancing dealer services cannot be the justification for exclusive dealing. Klein, *supr*a note 15, at n. 99.

[17] The discussion of self-enforcing contractual mechanisms in the category captain context is an application of the work on incomplete contracts and self-enforcement by Benjamin Klein and others. See, e.g. Klein & Leffler, The Role of Market Forces in Assuring Contractual Performance, 89(4) Journal of Political Economy 615 (1981); Klein, Why Hold-Ups Occur: The Self-Enforcing Range of Contractual Relationships, 34 Economic Inquiry 444 (1996); Klein & Murphy, Vertical Restraints as Contract Enforcement Mechanisms, 31 J. L. & ECON. 265 (1988); Klein & Murphy, Vertical Integration as a Self-Enforcing Contractual Arrangement, 87 Am. Econ. Rev. 415 (1997).

environments and the competitive process.[18] The strand of incomplete contracts literature emphasizing self-enforcement of contractual arrangements, as opposed to understanding contract terms as minimizing transactor malincentives given that performance cannot be directly contracted on, has significantly increased the state of knowledge regarding the contracting process.

One important contribution of this literature was providing a theoretical framework for understanding the role of increased prices as a mechanism to assure supply of quality services by a retailer.[19] This framework allows category management to be understood as one method by which manufacturers earn a return on their compensation to retailers for shelf space, whether those payments are per unit time or per unit sale.[20] Analysis of contract terms in this self-enforcement framework has helped to explain the role of distribution arrangements such as RPM, exclusive territories, as well and franchise

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[18] See, e.g., Klein, Crawford and Alchian, Vertical Integration, Appropriable Rents and Competitive Contracting Process, 21 J. L. & ECON. 297 (1978); Klein, Why Hold-Ups Occur: The Self-Enforcing Range of Contractual Relationships, 34 Economic Inquiry 444 (1996); Klein & Murphy, Vertical Restraints as Contract Enforcement Mechanisms, 31 J. L. & ECON. 265 (1988); Klein & Murphy, Vertical Integration as a Self-Enforcing Contractual Arrangement, 87 Am. Econ. Rev. 415 (1997); Williamson, The Economic Institutions of Capitalism (1985); Klein, Fisher-General Motors and the Nature of the Firm, 43 J. L. & ECON. (2000).

[19] See Klein & Leffler, *supra* note 17.

[20] A per unit sale payment in the form of a reduction in the wholesale price in conjunction with RPM is complementary to the per unit sale payment and necessary when inter-retailer competition is likely to compete away the manufacturer's compensation for shelf space.

agreements.[21] This Section analyzes exclusive dealing between manufacturers and retailers as a self-enforcing arrangement. Like exclusive dealing, category management arrangements are self-enforcing, but involve different implicit promises being made between the manufacturer and retailer. The implicit promises of category management arrangements will be discussed in Section 4.

A self-enforcement mechanism operates when parties can impose sanctions on each other by threatening the termination of the relationship for non-performance of the written and unwritten terms of the contractual understanding.[22] In a world of necessarily incomplete contracts caused by measurement and monitoring costs, transactors knowingly leave themselves susceptible to some possibility of hold-up. The role of contract terms under this view is not solely to create incentives for some court-enforceable notion of performance, but also to broaden the self-enforcing range of the parties' contractual understanding.

Consider one party to a contract contemplating "holding-up" the other party by engaging in some type of non-performance with respect to a written or

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[21] See Klein & Murphy, Vertical Restraints as Contract Enforcement Mechanisms, 31 J. L. & ECON. 265 (1988); Benjamin Klein, Distribution Restrictions Operate By Creating Dealer Profits: Explaining the Use of Maximum Resale Price Maintenance in State Oil v. Khan, 9 Sup. Ct. Econ. Rev. 1 (1999); Klein, The Economics of Franchise Contracts, 2 Journal of Corporate Finance 9 (1995). As suggested in this paper, the analysis also provides a framework for understanding per unit time payments to retailers for shelf space – slotting allowances. See Benjamin Klein & Joshua Wright, The Economics of Slotting Arrangements (working paper, available from the authors).

[22] Klein & Murphy, *supra* note 13.

unwritten term of the understanding. Transactors evaluate the short term gains earned from cheating on the agreement, i.e., not performing consistently with the contractual understanding. If this value is less than the discounted expected future profit stream a transactor will lose if the relationship is terminated for non-performance, performance is assured.

For simplicity, define W_1 as the short-term gain from cheating on the agreement and W_2 as the capital cost of the sanction imposed on the firm when it deviates from the performance contemplated by the agreement.[23] W_2 measures the ability of a party to sanction a non-performing party, and represents the transactor's reputational capital.

Contract terms themselves play a role in facilitating self-enforcement.[24] In order to ensure performance, transactors desire to design a contract that will economize on limited reputational capital and maintain $W_2 > W_1$ for the widest range of possible contingencies. In this sense, contract terms can be seen as facilitating self-enforcement by either reducing W_1 or increasing W_2. The

[23] In the simple version of this model, the decision faced by the firm is identical to that of the agent in infinitely repeated prisoner's dilemma games. By stretching out the time horizon the game is played, one increases the level of "punishment" available to the agents increases the probability that the cooperative solution is attained. The original model by Klein & Leffler makes this point, see *supra* note 17, at n.11. The model can be extended by assuming a finite life time for the agents. The key economic link between the models is the relationship of time horizon to the probability of a self-enforcing equilibrium.

[24] This explanation of the role of contract terms in self-enforcing arrangements is a summary of the theory discussed in Klein, The Role of Incomplete Contracts in Self Enforcing Relationships, 92 Revue D'Economie Industrielle 67 (2000).

economics literature focuses on the role of contractual specification in decreasing W_1, the gains from short-run deviations from the understanding. However, it would be prohibitively costly to reduce W_1 to zero or suppress it below the value of the expected future profit stream from the agreement. By economizing on available, but limited reputational capital, transactors may include contract terms that increase W_2.

4. Designating a Category Manager Allows Retailers to Obtain the Ability to Sell Shelf Space While Minimizing Loss of Product Variety

Understanding the benefits of exclusive dealing in facilitating an efficient solution to the incentive incompatibility between the manufacturer and distributors provides the basis for understanding category management contracts. However, the key economic insight linking exclusive dealing and category management is best viewed by examining the costs of an exclusive dealing arrangement. Specifically, an exclusive dealing arrangement is costly in the somewhat obvious sense that it reduces the variety faced by consumers.

Retailers face a trade-off between carrying a reduced variety and accepting a manufacturer's payment for extra promotional effort, or selling increased variety without manufacturer subsidization of promotion. Where consumer demand for variety is high, exclusivity does not make economic sense for the retailer. Under the condition that distributors operate in competitive

industries, retailers will have the correct incentive to choose the profit-maximizing combination of variety and manufacturer subsidy. Where consumers value variety, it will not pay for retailers to grant manufacturers exclusives. In these instances of high consumer demand for variety, category management is a less restrictive alternative to appropriating the benefits of exclusivity in terms of reducing distributor incentive to promote rival products.

Consumers are likely to have a strong preference for variety in some circumstances. Where consumers value variety, a retailer granting a manufacturer an exclusive right to shelf space is likely to suffer costs associated with customers switching retailers in order to seek greater product variety, or otherwise reducing purchases. Designating a category manager for products where consumers demand variety allows the retailer to obtain the benefits of (1) receiving manufacturer payments for shelf space in the form of per unit time or per unit sale discounts, (2) maximizing the return received by retailers by making the shelf space sold to the manufacturer more valuable; and (3) minimizing the costs associated with loss of product variety.

Designation as a category manager provides the manufacturer some of the benefits of an exclusive. Specifically, giving the manufacturer the right to control the retailer shelf space decisions with respect to product allocation significantly reduces the ability of the retailer to promote rival products. Like exclusive

dealing, designation of a category manager reduces the retailer's incentive to promote rival products and is therefore an alternative method of facilitating the contractual arrangement. Because the retailer's ability to deviate from the promotion contract is limited, manufacturers with rational expectations will purchase shelf space in order to induce incremental sales.

A second benefit of designating a category manager is that it increases the value of the shelf space sold to the manufacturer. Even without prevention of retailer "free-riding" on the manufacturer's shelf space payments, granting the manufacturer a category manager position may increase the value of the shelf space provided to manufacturers and therefore maximize the return earned by retailers providing promotional services.[25] To understand why the value of the shelf space might increase by selling to a manufacturer along with the right to provide category management services, one must start with the analysis of why selling the manufacturer an exclusive might do so.

In some circumstances, a retailer may grant a manufacturer an exclusive on its shelf space because it is efficient to deliver all of the customers to one manufacturer. The reason that it might be efficient for a manufacturer to deliver all of its customers to one manufacturer, even without the added benefits of eliminating retailer free-riding on the manufacturer's shelf space payments by

[25] See Klein, *supra* note 15, at 50.

promoting rival products, is because the retailer may be able to increase the elasticity of demand faced by each manufacturer bidding for the shelf space exclusive. In other words, because each manufacturer knows that the retailer is delivering all or most of its customers to the manufacturer who wins the bid for the retailer's shelf space, the manufacturer's willingness to drive the wholesale price down (or increase the per unit time payment) is greater than if the manufacturer's product was on the shelf competing with other products.[26]

Designating a particular manufacturer as category manager is another method by which a retailer may increase the value of its shelf space under conditions where consumers' demand for variety imposes costs sufficient to make granting an exclusive uneconomical. Even under conditions where category management did not facilitate enforcement of the contract by reducing or eliminating the incentive of retailers to use the category manager's space to promote rival products, designating a category manager increases the value of the shelf space provided to the retailer. Like granting an exclusive to the manufacturer and therefore delivering all or most of the retailer's customers,

[26] Benjamin Klein argues that this analysis might explain the shelf space contracts in FTC v. McCormick (FTC File NO. 961-0050). See Klein, *supra* note 15, at 52. Klein's analysis suggests that because the particular brand of spices sold at a grocery store is not a major determinant of where consumers decide to shop, the costs associated with reduction of product variety are not high. Under these conditions, the retailer may "deliver" all or most of its customers to the manufacturer and therefore increase the value of the shelf space offered to the retailer and in turn, increase the payments received from the manufacturer.

designating a category manager is a method by which the retailer can commit to featuring a particular brand and providing extra shelf space to that manufacturer. Delivery of the "extra" shelf space and featuring the manufacturer's product delivers a greater number of sales to the category manager than it would otherwise receive and therefore increases the value of the shelf space and the manufacturer's willingness to pay.

It is obvious that featuring the manager's product is likely to decrease product variety less than if an exclusive is granted. The more important economic point is that designating a category manager is a way for the parties to obtain some of the benefits of exclusive dealing in terms of increasing the value of the shelf space, while minimizing the costs associated with reducing product variety.[27] In product markets where consumer demand for variety is not such

[27] One way to think about a category manager designation is as the retailer providing an "exclusive promotion" contract rather than an exclusive on the retailer's shelf space. The implicit understanding between the manufacturer and retailer is essentially that the retailer will only promote the manager's product through the provision of a greater quantity and quality of shelf space. In turn, the manager's obligation is to pay for the shelf space with a per unit time or per unit sale contract, and to make recommendations to the retailer or design shelf space allocations that will not harm the retailer in terms of reduced variety. A similar method of obtaining the benefits of exclusive promotion while minimizing the costs associated with demand for product variety is to contract, where feasible, for exclusive promotion of one product while allowing customers who demand another variety to receive that product upon request. Benjamin Klein suggests that this analysis describes Microsoft's contracts with Internet access providers such as America Online, who agreed to exclusively promote Internet Explorer for two years and contractually guaranteed that a minimum of 85% of new subscribers would use Internet Explorer technology. Klein, *supra* note 15, at 53-55. The designation of a category manager or use of a contractual device to ensure the satisfaction of those consumers with a specific demand for another product are alternative methods for limiting the costs associated with reduced product variety while obtaining the benefits of exclusive promotion, specifically, increasing the value of the promotional effort sold to the manufacturer.

that the reduction in variety associated with featuring a particular product is prohibitively costly, designating a category manager is a method available to retailers to increase the value of the shelf space they offer to manufacturers. Retailers therefore force manufacturers seeking this extra promotion, and specifically the increased profits from obtaining incremental sales, to compete for delivery of a larger number of customers. This increased incentive to compete for distribution as a result of the increasing elasticity of demand faced by each manufacturer maximizes the return to the retailer from the sale of their customer base and increases the payments made to retailers in per unit time or per unit sale form. The increase in payments results in either a greater reduction in the wholesale price than would be obtained from competition between retailers on the shelves without a manager, or an increase in per unit time payments to the retailer. In either event, competition at the retail level passes these payments on to customers in the form of a reduced retail price or an increase in quality supplied.[28]

[28] One concern regarding per unit time payments such as slotting allowances is that they will not be passed on to consumers, in contrast to wholesale price reductions or per unit sales shelf space payments. However, this analysis assumes that competition will only occur on one margin, the price of the category manager's good. Given free entry into grocery retail, any payments above the competitive rate of return can be expected to be competed away. Lump sum payments such as slotting allowances may be competed away by price discounts on products likely to increase grocery traffic rather than the category manager's product.

4.1. The Self-Enforcement Mechanism of Category Manager Contracts

This Section explores the implicit understanding that might exist between the parties in category management contracts and the self-enforcement mechanism of such implicit contracts.

Analysis of the self-enforcing contractual arrangement starts with defining the implicit understanding between the category manager and the retailer. The implicit understanding regarding the terms of retailer performance is to supply the level of shelf space desired by the manufacturer. On the manager side, however, the agreed upon performance us likely to vary. For example, a retailer may expect the manager to make suggestions regarding shelf space allocation, provide data, or it may give complete control of the shelf space allocation decisions to the manager. The manager is also expected to supply a sufficient level of product variety. Self-enforcement analysis suggests that each party to the contract will continue to perform in a manner consistent with the implicit understanding so long as the expected premium stream earned by the party over the life of the agreement is greater than the gains from cheating. Using the framework above, the parties will continue to perform as long as $W_2 > W_1$. The following section explores the performance decision faced by both the retailer and the manager.

A. Retailer Performance is to Supply Promotional Effort

The retailer's performance is the supply of shelf space featuring the manager's product. The retailer's gains from short-run cheating on the category management relationship, W_1, is defined by the gains from the retailer from promoting a rival product or supplying less than the agreed upon level of shelf space to the retailer. As discussed above, exclusive dealing significantly reduces the incentive of the retailer to deviate from the agreement and therefore facilitates contractual enforcement. Likewise, designating a manufacturer as category manager reduces the retailer's incentive to cheat by placing the shelf-space decisions in the hands of the manager. Reducing the incentive to cheat increases the probability that the category management relationship remains within the self-enforcing range over the maximum number of possible contingencies. On the other hand, W_2, the premium stream earned by the retailer, consists of the per unit time or per unit sale payments paid by the manufacturer over the duration of the agreement. From the retailer's perspective, designating a category manager allows the retailer to earn not only the benefits of manufacturer payments, but also minimize the costs associated with the reduction in product variety.

B. Manufacturer Performance is to Supply Promised Variety

The manager's performance is the supply of a sufficient level of product variety. Therefore, manager cheating may be defined as supply of less than the "optimal" level of variety. The implicit understanding is that the manager will feature his own product by allocating it a greater quantity and quality of shelf space than the manager would receive without payments. However, the manager is also expected to provide sufficient variety with the remaining shelf space such that the allocation minimizes the costs imposed on the retailer by the reduction in variety. Therefore, the gains from manager short-run cheating on the category management relationship, W_1, are defined by extra profits earned by the manager by supplying its own product "too much" shelf space. W_2, the gains to the retailer from continued performance, is defined as the "extra" profits earned by the manager over the duration of the agreement by receiving the "featured" quantity and quality of shelf space from the retailer. Because the manager stands to lose these extra profits upon termination, the manager will provide a sufficient level of product variety as long as $W_2 > W_1$.

The economics of self-enforcing contractual arrangements shed some light on the category management relationship and the implicit understanding between the parties, as well as the benefits flowing to both the manager and the retailer as a result of the agreement. USTC was recently found to have abused its

category manager position in violation of the Sherman Act in a number of ways, including unauthorized removal and destruction of competitors' display racks and product. The self-enforcement analysis in this section would suggest that the retailers would be protected from such manager conduct clearly outside the implicit understanding of the relationship with the threat of terminating the relationship.

Having completed the economic analysis of category management within the self-enforcement framework, Section 5 proceeds with an analysis of the antitrust law of category management and the legal duties faced by category managers.

5. Antitrust Law and Category Management

Antitrust law has generally accepted the economic justification for exclusive dealing that is at the heart of the economic analysis of category management in this paper: prevention of retailer free-riding on the manufacturer's compensation. While category management has rarely been addressed by antitrust law specifically, the economic analysis above suggests that category management is a less restrictive means of achieving prevention of retailer free-riding on the manufacturer's compensation mechanism than exclusive dealing. It follows that one would expect a more lenient antitrust standard applied to category management than to exclusive dealing.

Paradoxically, *Conwood*, the only appellate level decision directly addressing the legal duties facing a category manager and providing guidance to counsel advising firms implementing category management programs, appears to impose greater legal duties on category managers.

This Section addresses the economic conditions under which an anticompetitive effect may result from a dominant manufacturer's use of exclusionary contracts with distributors, recent developments in the antitrust law of distribution contracts, and concludes with an analysis of the landmark "category management" decision in *Conwood*.

5.1. When Exclusive Distribution Contracts May be Anticompetitive

The sale of a product often involves two stages, manufacturing and distribution. A manufacturer produces the product and sells it to a distributor, who then sells it to consumers. The sale of grocery products obviously exhibits this structure. Economic analysis of distribution contracts between a manufacturer and distributor may be anticompetitive under certain conditions. Specifically, distribution contracts may successfully exclude rivals if a manufacturer with market power is able to achieve a sufficient share of distribution so that a manufacturer's rivals are forced to operate at a significant cost disadvantage for a significant period of time.

The share of distribution achieved by the manufacturer is often referred to in the antitrust literature as the level of foreclosure. Typically, foreclosure is discussed in the context of exclusive dealing contracts by which a manufacturer binds a distributor to commit to promote and sell only the manufacturer's product. However, the economic analysis can be applied more broadly to include distribution contracts that commit the distributor to a particular percentage of distribution or by which the manufacturer is able to create a de facto exclusive environment for rivals.

If a manufacturer is able to contractually foreclose a sufficient share of distribution to rivals so that the remaining distribution cannot support a manufacturer of minimum efficient scale, anticompetitive effect may be achieved because existing competitors and potential entrants may be forced to operate at a cost disadvantage until sufficient additional distribution becomes available. It is therefore possible that a manufacturer's distribution contracts may by exclusionary by driving out and/ or preventing entry of manufacturing competitors.

Easy entry into distribution may prevent a manufacturer from successfully excluding rivals. Where the supply of distribution services is highly elastic, it follows that a manufacturer cannot exclude its rivals from access to distribution. If, for example, product manufacturers compete by obtaining

exclusive contracts, a new entrant would be forced to arrange for independent distribution. Independent distribution may be arranged for either by switching to existing distributors at the expiration of the contract term or by contracting with new entrants into distribution. Where entry into distribution is easy, it is highly unlikely that exclusive dealing contracts or contractual arrangements that otherwise foreclose rivals from distribution services could significantly deter entry.

The analysis is altered slightly in the grocery store context where the retailer is a multi-product distributor. The economic significance of this distinction is that the manufacturer's product is only a small fraction of the distributor's total sales. Despite free entry into distribution, it is not likely to be economic for a product manufacturer to vertically integrate into distribution or for new distributors to serve rivals. A manufacturer is left to contract for distribution with existing distributors.

With this background, a number of conditions must be present in order for a set of distribution contracts to create or maintain manufacturer market power. These conditions can be derived from considering the analogy of the distribution arrangements to a conspiracy among distributors organized by a dominant manufacturer. In other words, the distributors and manufacturers work together to monopolize distribution or both distribution and

manufacturing and share the industry monopoly profits.[29] By considering the incentives of an individual distributor to remain outside of the arrangement, like all cartels, it is not difficult to see the difficulties in successfully achieving anticompetitive exclusion.

This cartel analysis reveals that one requirement of a successful exclusionary strategy is that economies of scale must exist at the manufacturing level. Consider the case where economies of scale in manufacturing are not significant. An individual distributor has more to gain by remaining outside the conspiracy and contracting with a rival manufacturer. A competitive manufacturer in this case can survive at a limited scale and therefore do not require a large number of distributors. The cost to a manufacturer of blocking rivals from access to distribution and therefore creating or maintaining market power is very high. Like the incentive to cheat on a collusive agreement by expanding sales, a distributor would find it more profitable to contract with a rival manufacturer.

Conversely, where there are significant economies of scale in manufacturing, the potential for a stable, exclusionary distribution arrangement increase. A dominant manufacturer must cover enough distribution for a

[29] This analysis has been shown to describe the role of Standard Oil in enforcing the collusively agreed upon individual railroad market shares. See Elizabeth Granitz & Benjamin Klein, *supra* note 5.

sufficient period of time so that a rival manufacturer is rendered unable to reach minimum efficient scale. A rival forced to reduce scale as a result of the scarcity of distribution operates at higher average costs and is therefore less able to discipline a price increase by the dominant manufacturer.

Not all arrangements by a dominant manufacturer, which successfully cover a sufficient share of distribution where significant economies of scale are present in manufacturing, result in an anticompetitive effect. Economies of scale in distribution play an important role in the economic analysis. Consider the case of significant economies of scale in distribution. In this case, an individual distributor can supply a manufacturer of minimum efficient scale and therefore, a dominant manufacturer would be forced to exclude a rival from each distributor in order to ensure that the rival was effectively excluded. In other words, any rival would defeat this exclusionary tactic by winning a single distribution contract. Even where contracts become available intermittently as a result of staggered expiration dates, it is unlikely that a manufacturer could exclude a competitive manufacturer from the market.

5.2. The Antitrust Law of Exclusionary Distribution Contracts

The legal analysis of distribution contracts, including exclusive dealing contracts, is largely consistent with the economic analysis above. However, legal analysis in monopolization cases can vary from sophisticated attempts at

understanding the probability of anticompetitive effect based on an examination of the necessary conditions set forth above to unjustified findings of anticompetitive effect based upon neither economic theory nor empirical verification. This section summarizes modern monopolization jurisprudence with respect to distribution contracts, including exclusive dealing contracts, promotional arrangements, and distribution contracts that otherwise disadvantage rivals.

The paradigmatic standard under Section 2 of the Sherman Act was set forth by the United States Supreme Court in *Grinnell*:[30]

> The offense of monopoly under Section 2 of the Sherman Act has two elements: (1) the possession of monopoly power in the relevant market and (2) the willful acquisition or maintenance of that power as distinguished from growth or development as a consequence of a superior product, business acumen, or historic accident.

The *Grinnell* standard stands as the classic formulation of monopolization analysis and was recently relied on by the Supreme Court in *Kodak*.[31] Both the

[30] United States v. Grinnell Corp., 384 U.S. 563, 570-71 (1966).

[31] Eastman Kodak Co. v. Image Technical Servs., Inc., 504 U.S. 451, 481 (1992).

monopoly power element and the "conduct" element of the *Grinnell* standard have proven difficult to apply for district and appellate courts.[32]

A. Manufacturer Monopoly Power

As Timothy Muris has written, the monopoly power element necessarily requires economic analysis because that power is defined as the ability to raise the industry price and restrict industry output.[33] A firm without monopoly power does not have the ability to create competitive harm and cannot exclude rivals without a collusive agreement or by conduct such as obtaining a patent by fraud or destroying a rival's product. Collusion is adequately handled under the price-fixing provisions of Sherman Act § 1, while fraud, disparagement and product destruction are regulated by other laws. For a firm to successfully exclude rivals, these anomalies aside, it must have monopoly power.

Recent decisions have inferred this level of monopoly power from observations of market shares in the relevant market ranging from 50 percent to

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[32] See Einer Elhauge, Defining Better Monopolization Standards, 56 Stan. L. Rev. 253, 258-268 (2003), for a critique of the currently uncertain standards on the grounds that the elements prove prohibitively difficult to administer and do not provide meaningful guidance to courts and juries.

[33] See Timothy J. Muris, The FTC and the Law of Monopolization, 67 Antitrust Law Journal 693 (2000). Note that the term "market power" as I will use in this paper, and as it is used in most antitrust decisions, refers to monopoly power – the power to restrict market output or increase the market price. Market power, in the economic sense, is quite a different phenomenon rooted in the downward sloping demand curves that are not perfectly elastic, and therefore give the firm a modicum of pricing discretion but not the ability to affect the market price. See Benjamin Klein & John Wiley, Jr., Competitive Price Discrimination as an Antitrust Justification for Intellectual Property Refusals to Deal, 70 Antitrust Law Journal 599 (2003).

70 percent.[34] The paradigmatic market share guideline for monopoly power has been that shares less than 33 percent are not sufficient, shares greater than 90percent are sufficient, and shares between 50-70 percent might be sufficient.[35]

B. Bad Conduct and Substantial Foreclosure

One reading of the "conduct" element of the *Grinnell* test has been that the monopolist's conduct is not actionable unless it is "anticompetitive or exclusionary." The *Aspen* Court defined "anticompetitive or exclusionary" behavior as that which "tends to impair the opportunities or rivals, but also either does not further competition on the merits or does so in an unnecessarily restrictive way."[36] Economic analysis indicates that without foreclosure of a rival's access to distribution, a monopolist's contracts with distributors cannot satisfy this definition and create or maintain monopoly power.

Analysis of sufficient foreclosure of the relevant market has been at the heart of vertical restraint analysis in antitrust cases for decades.[37] *Standard*

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[34] See Posner, Antitrust Law at 196 n. 6 and the cases cited therein for a sense of the range of market share thresholds across the appellate circuits.

[35] See Eastman Kodak, 504 U.S. at 481 (80-95percent is sufficient to survive summary judgment); Grinnell, 384 U.S. at 571 ("In the present case, 87 percent [market share] leaves no doubt that . . . defendants have monopoly power . . . if that business is the relevant market").

[36] Aspen Skiing Co. v. Aspen Highlands Skiing Corp., 472 U.S. 585, 595-96 n. 32 (quoting the formulation in III Phillip Areeda & Donald F. Turner, Antitrust Law: An Analysis of Antitrust Principles and Their Application 78 (1978)).

[37] The Supreme Court's last exclusive dealing case, Tampa Electric v. Nashville Coal Co., 365 U.S. 320 (1960), concluded that an exclusive dealing contract covering less than one percent of the relevant distribution market was not a violation of the antitrust laws.

Fashion and *Standard* Stations found antitrust liability for foreclosure levels of 40 and 49 percent, respectively.[38] However, several courts of lower federal courts have granted antitrust liability for lesser levels of foreclosure.[39] In the tying context, *Jefferson Parish* has established that foreclosure levels of less than 30 percent are not sufficient for liability.[40]

The economic analysis above implies that the critical level of foreclosure should depend upon the minimum efficient scale of production. Unless there are large economies of scale in manufacturing, the minimum level of foreclosure necessary for an anticompetitive effect in most cases would be substantially greater than 40 percent. Therefore, a 40 percent share of distribution can be thought of as a useful screening device or "safe harbor," rather than an indication that anticompetitive effects are likely to exist at distribution shares exceeding this level. Nonetheless, modern antitrust law continues to require sufficient foreclosure in order for antitrust liability to follow.

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[38] Standard Fashion Co. v. Magrane-Houston Co., 258 U.S. 346 (1922); Standard Oil Co. v. United States, 337 U.S. 293 (1949).

[39] See Jonathan M. Jacobsen, Exclusive Dealing, "Foreclosure," and Consumer Harm, 70 ANTITRUST L. J. 311, 362 (2002). Jacobsen describes the state of the foreclosure requirement in exclusive dealing since Beltone Electronics Corp., 100 F.T.C. 68 (1982), as generally condoning arrangements with foreclosure percentages of 40percent or less. Id. at 325. Jacobsen characterizes exclusive dealing law as requiring only that the exclusive dealing arrangement have a significant impact on the defendant's market power, and not necessarily sufficient foreclosure. However, the defendant's market power cannot be affected without sufficient foreclosure.

[40] Jefferson Parish Hospital District No. 2 v. Hyde, 466 U.S. 2 (1984).

However, analysis of foreclosure in distribution markets raises at least two interesting problems. One considers the appropriate market definition at the distribution level, i.e. whether a significant share of the most cost-effective distribution channels but not of total distribution, should be sufficient for a finding of the requisite foreclosure. The second issue is specific to foreclosure of shelf space and involves the use of the "shelf space to sales doctrine" which essentially finds the requisite level of foreclosure where a manufacturer's share of distribution exceeds its product market share.

1. Foreclosure of Cost-Effective Distribution Channels

Rather than calculating the percentage of total distribution bound by the manufacturer's contracts, courts have found the foreclosure requirement satisfied in situations where the foreclosure of total distribution would be insufficient, but the manufacturer has foreclosed a significant share of a particular type of distribution channel. The underlying conflict among the circuit courts is exemplified by comparing the D.C. Circuit's ruling in *Microsoft* with the Ninth Circuit's analysis in *Gilbarco*.[41]

The district court's analysis in *Microsoft* concluded that Microsoft's de facto exclusive distribution contracts with Internet access providers and personal

[41] United States v. Microsoft Corp., 87 F. Supp. 2d 30 (D.D.C. 2000) *rev'd in part, aff'd in part*, Microsoft Corp. v. United States, 253 F.3d 34 (D.C. Cir. 2001)(en banc), cert. denied, 534 U.S. 952 (2001); Omega v. Gilbarco, 127 F. 3d 1157 (9th Cir. 1997).

computer manufacturers did not violate Section 1 because it found that the contracts did not cover more than 40 percent of distribution.[42] The D.C. Circuit noted its disagreement with the decision, but did not reverse the ruling which was not challenged by the plaintiffs.

Interestingly, the D.C. Circuit fully accepted the district court's conclusion that the same contracts violated Section 2 because they permitted Microsoft to control a substantial share of the browser market in an attempt to illegally maintain Window's dominance in the operating system market.[43] One potential reading of these conflicting holdings is that Section 2 is more restrictive than Section 1. Such an interpretation is counter-intuitive and does not take into account the D.C. Circuit's consideration of the "cost-effectiveness" of the different distribution channels. The D.C. Circuit, by explicitly placing greater weight on Microsoft's share of cost-effective browser distribution, found that Microsoft's share exceeded 40 percent. This interpretation suggests a consistent minimum foreclosure standard under Sections 1 and 2.[44]

The Ninth Circuit's analysis in *Gilbarco* rejected the notion that Gilbarco's success in its attempt to procure the most efficient distributors was actionable under the antitrust laws. *Gilbarco* was a Clayton §3 case brought by plaintiff

[42] 87 F. Supp. 2d at 52.

[43] 253 F.3d at 70-71.

[44] This point is consistent with Benjamin Klein's prior analysis, *supra* note 15.

Omega Environmental, Inc. The defendant, Gilbarco Co., was a manufacturer of petroleum dispensing equipment who sold their products both directly and through authorized dealers to the owners of retail gasoline outlets and other purchasers of such equipment.[45] Gilbarco was the market leader, capturing nearly 55% of the domestic market for dispensers in 1995.[46]

Manufacturers of petroleum dispensing equipment distribute their products through a number of channels. Gilbarco for example, sold approximately one-third of its sales directly to end users while the remaining dispensers are sold through authorized distributors.[47] Other distributors focus primarily on major oil companies and jobbers.[48]

Omega proposed to enter the industry by providing "one-stop shopping" to consumers of petroleum dispensers. Its plan was to develop a national service and distribution network by purchasing existing concerns, and allowing Omega distributors to offer multiple product lines.[49] Omega, as part of this plan, purchased two Gilbarco authorized distributors.[50] Gilbarco quickly notified the newly acquired Omega distributors under contract to Gilbarco that it "intended

[45] Id. at 1160.

[46] Id.

[47] Id.

[48] Dresser Wayne, the second leading dispenser manufacturer, for example, sold 70% of its dispensers directly to the major oil companies and jobbers. Id.

[49] Id.

[50] Omega purchased ATS-Omega and Kelley-Omega. Id.

to continue to do business with service station equipment distributors who sell only the Gilbarco line of retail dispensers."[51] Gilbarco subsequently gave its contractually required 60 days notice and terminated the agreement. Omega promptly sued upon termination and won a $9,000,000 award which was trebled to $27,000,000 on the basis of a number of claims including an exclusive dealing claim under the Clayton Act.[52]

The court then moves on to analyze the potential anticompetitive effect caused by Gilbarco's distribution arrangements. The relevant market was defined as "the sale of retail gasoline dispensers from manufacturers in the United States."[53] The Ninth Circuit majority's algebra indicates the Gilbarco's exclusive dealing arrangements cover 38 percent of the market for distribution.[54]

Despite the relatively significant percentage of distribution foreclosed, Judge Wright describes the 38 percent figure as an "overstatement" of the "size of foreclosure and its likely anticompetitive effect for several reasons."[55] Judge Wright concluded that the evidence of foreclosure was legally insufficient because alternative means of distribution were present, such as direct sales to

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[51] Id. at 1161. Because Gilbarco controls 55 percent of the total market, and 70 percent of its sales are through exclusive dealing arrangements with authorized distributors, the product of these two percentages gives a 38 percent foreclosure level.

[52] Id.

[53] Id.

[54] Id.

[55] Id.

end-users. Because of the existence of these alternative means of distribution eliminate the potential danger of Gilbarco's exclusive arrangements in the authorized dealer channel.

Significantly, Omega contended that even if the percentage foreclosed was not legally sufficient, the fact that Gilbarco had tied up the "best available" distribution options and those distributors were highly unlikely to depart from contractual relations with market-leader Gilbarco for a competitor. The majority rejected the notion that Gilbarco's success in its attempt to procure the most efficient distributors was actionable under the antitrust laws. In particular, the panel majority considered Gilbarco's significant share of the cost-effective distribution channels indicative of Gilbarco's superiority.[56]

Microsoft and *Gilbarco* provide a contrast of the analysis applied in different federal circuits with respect to foreclosure of distribution. The economic analysis suggests that the key inquiry is an examination of whether the defendant's conduct has prevented a rival from attaining minimum efficient scale. Where economies of scale are present, it therefore seems appropriate to give greater weight to the most effective distribution channels if a rival is unlikely to be able to attain minimum efficient scale without access to those channels. The non-uniformity of foreclosure analysis on this issue, however,

[56] Id. at 1163.

imposes a significant degree of uncertainty regarding antitrust liability on manufacturers with monopoly power and their competitive strategies for product distribution.

2. Shelf Space to Sales Ratio

In cases involving distribution via shelf space, some district courts have determined that the proper foreclosure percentage can be measured by a handy approximation that has been termed the "space to sales" ratio. The space to sales doctrine asserts that a manufacturer whose percentage of shelf space is greater than its product market share achieved sufficient foreclosure.[57]

Use of the "space to sales" ratio substitutes a less sophisticated and less accurate analysis, although substantially more convenient, for the level of rigor required to assess the true likelihood of an anticompetitive effect. An inference

[57] This practice likely began as a result of the FTC investigation of ready-to-eat cereals. See 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 overstocks, increase efficiency and profitability and reduce labor costs." Findings of fact, ¶ 460. The findings of fact also stated that "sales volume is, and has been, the basic method of space allocation throughout grocery stores." Id. at 461. Subsequent federal courts have used this "space to sales" rule as a guideline in slotting fee monopolization cases. Firms that do not obtain a percentage of shelf space greater than their respective market share are likely to be found not to violate antitrust laws. See Frito Lay, Inc. v. Bachman Company, 659 F. Supp. 1129,1134 (S.D.N.Y. 1986)(dismissing Section 1 claim due to failure to allege that Frito Lay obtained a greater share of shelf space than its market share); Bayou Bottling v. Dr. Pepper, 725 F. 2d 300, 303 (5th Cir. 1985)(using the "space to sales" guideline to reject a monopolization claim). In a more recent case, El Aguila Food Products Inc. v. Gruma Co., 2003 U.S. Dist. LEXIS 24411, the district court rejected claims that Gruma had excluded plaintiff tortilla manufacturers from shelf space and harmed competition partially on the grounds that Gruma's shelf space was not disproportionate to sales. Id. at *52 (citing Louisa Coca-Cola Bottling Co. v. Pepsi Cola Metro Bottling Co., 94 F. Supp. 2d 804, 814-15 (E.D. Ky. 1999)).

of competitive injury cannot be made simply because one firm has obtained a share of shelf space distribution that exceeds its market share. There is no sound economic basis for the "space to sales" ratio.

The key economic question of foreclosure is whether or not rivals are prevented from reaching minimum efficient scale. The answer to this question is likely to require in-depth knowledge of the cost conditions of the industry, which will obviously vary and necessitate a "hands on" analysis of the facts. In particular, the level of foreclosure necessary for anticompetitive effect is dependent on the magnitude of scale economies in manufacture. A rule of thumb such as "space to sales" may surely be a useful tool for retailers deciding how to allocate shelf space, but it is misguiding as a tool for antitrust analysis.

C. Duration and Terminability of Contract

The economic importance of the duration of the contract is that under a longer contract, a manufacturer seeking distribution of its product may not be able to find efficient channels for distribution and therefore may be deterred from entry for a significant period of time. The delay of entry may cause anticompetitive injury while rival manufacturers look to realign with new entrants. Under a shorter contract, a manufacturer need only time its entry such that sufficient distribution is available for the manufacturer upon the expiration of the exclusive term.

However, even under exclusive contracts that are terminable at will, achieving sufficient distribution to achieve minimum efficient scale may be postponed if a large number of distributors cannot be convinced to terminate their contracts. Because of the staggered expiration dates of shorter term exclusive contracts, a potential entrant may take longer to reach minimum efficient scale and therefore will operate at higher costs for a period of time if economies of scale exist in the industry.

Antitrust law incorporates the economic significance of the distribution contract's duration. The length of exclusive contract has been a primary emphasis of antitrust law when dealing with Sherman Act §2 and Clayton Act §3 cases. In some cases, courts have found that the length of exclusion is a dispositive factor in the analysis. For example, Judge Posner held that arrangements lasting less than one year would be "presumptively lawful."[58] Much like the degree of the market foreclosed in terms of market share, many courts have subsequently focused on the duration of the exclusivity clause in the challenged contract. Some have followed *Roland Machinery*'s analysis, while others have found that even short term contracts could potentially cause competitive harm where contracts were in fact, difficult to terminate.[59]

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[58] Roland Mach. Co. v. Dresser Indus., Inc., 749 F.2d 380, 395 (7th Cir. 1984).

[59] The Ninth Circuit majority in *Gilbarco* found that the fact that "all of Gilbarco's distributors are available within one year, and most available on 60 days notice," showed that competitors need

The economics of category management indicate that it is a less restrictive means of facilitating a manufacturer's compensation arrangement with distributors than exclusive dealing. It follows that the standard applied to a category manager's distribution arrangement should be more lenient than that applied to dominant manufacturers obtaining exclusives from distributors. Interestingly, this has not necessarily been so. At least one court has applied a more stringent standard to category manager conduct on the theory that the category management relationship imposes a type of fiduciary obligation running from the manager to the retailer and perhaps the consumer.

5.3. *Conwood Co. v. United States Tobacco Co.*[60]

The Sixth Circuit recently increased the risk of antitrust exposure to dominant firms entering distribution contracts when it affirmed a verdict of illegal monopolization under Sherman Act §2. The verdict, trebled from $350

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simply offer a better deal in order to persuade distributors to switch their allegiance. In an informative citation, the court refers to Judge Posner's holding in *Roland Machinery*, where the "short duration and easy terminability of these agreements negates substantially their potential to foreclose competition." 127 F.3d at 1163. Other recent cases have concluded that foreclosure occurred despite the fact that the contracts were terminable at will and of short duration because the contracts were difficult to terminate as a practical matter. See, e.g., United States v. Dentsply Inc., 2001-1 Trade Cas. (CCH) ¶ 73, 247 (D. Del. 2001); Minnesota Mining & Mfg. Co. v. Appleton Papers, Inc., 35 F. Supp. 2d 1138, 1144 (D. Minn 1999).

[60] 290 F.3d 768 (6th Cir. 2002).

million to $1.05 billion dollars in damages, is the second largest in antitrust history.[61]

A brief discussion of the moist snuff market and facts offered at trial regarding the competitive conditions in the market is offered first as a predicate to understanding the shortcomings of the Sixth Circuit's decision, as well as to provide the building blocks for understanding the high probability that USTC's conduct could not produce the anticompetitive effect that is requisite to a Sherman Act violation.

USTC was the leading manufacturer in the U.S. moist snuff market. USTC held approximately a 77% market share while Conwood, the plaintiff, held approximately 13%.[62] USTC manufactures the "Skoal" and "Copenhagen" brands while of moist snuff while Conwood manufactures the "Kodiak" and "Cougar" brands.[63] USTC dominated the market for most of the 1970s and 80s. The 90s exhibited increased entry in the market and a decrease in market share for USTC while the company imposed price increases of approximately 8-10% annually from 1979-88.[64]

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[61] See David A. Balto, "Sixth Circuit Upholds One Billion Dollar Antitrust Jury Verdict: Posing Significant Risks for Dominant Firms," White & Case LLP.

[62] 290 F. 3d at 774.

[63] Id. at 773.

[64] Id. at 774.

The Sixth Circuit opinion also emphasized a number of facts. First, the court emphasized the importance of in-store advertising and "point of sale" (POS) in the moist snuff market due to restrictions on tobacco advertising.[65] Second, USTC's strategy during the 1990s began to involve pursuing "exclusive racks." Despite the label, an "exclusive rack" refers to one manufacturer supplying a rack to the retailer to display its moist snuff products and those of all other manufacturers.[66] An exclusive rack essentially means that the manufacturer with the benefit of exclusivity may design allocation of moist snuff products on the rack pending approval of the retailer.[67] However, the monopolization charges in the *Conwood* case did not revolve simply around USTC's attempt to obtain exclusive racks at a number of retailers.

Perhaps the most unique and troubling allegations in the *Conwood* case were that USTC removed competitors' product display racks from stores without the permission of the store management, destroyed these racks in some cases, trained its salespeople to take advantage of inattentive store clerks in an effort to destroy Conwood racks, and misused its category management position by

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[65] Id. at 774.

[66] Id. at 775.

[67] The court also made reference to the fact that some retailers requested exclusive racks citing "uniformity" and "attractiveness" as benefits. It also pointed out that Wal-Mart and other retailers often hosted competitions amongst moist snuff manufacturers to design a rack for use in its stores. USTC argued to the court that Conwood had access to those competitions and chose not to compete in some cases. Id.

falsely informing and misleading retailers in order to maximize distribution of USTC product.[68]

At trial, Conwood was able to provide evidence supporting its claim that in some cases, USTC salespersons had removed the Conwood display racks without authorization.[69] In addition, USTC employees testified that they had orders from supervisors to destroy Conwood racks, and in some cases, employee compensation and bonuses depended on such rack destruction.[70] After an extensive trial, the district court jury deliberated for only four hours and returned the $350 million verdict in Conwood's favor.[71]

The Sixth Circuit's analysis applied the Sherman Act §2 standard in the context of the reviewing the district court's denial of a motion for judgment as a matter of law. The appellate issues are therefore analyzed under the premise that all evidentiary issues are viewed in the light most favorable to Conwood.[72]

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[68] Id. at 778-79.

[69] Id. at 777. Conwood representatives testified that it spent near $100,000 a month on replacement racks. Other evidence included claims by former USTC employees that those employees frequently removed competitor racks over a period of time.

[70] Id. at 780.

[71] Id. at 773.

[72] Id. at 781 (citing Williams v. Nashville Network, 132 F. 3d 1123, 1131 (6th Cir. 1997) (citing K & T Enterprises, Inc. v. Zurich Ins. Co., 97 F.3d 171 (6th Cir. 1996))).

Therefore, the Sixth Circuit was to grant the motion only if "reasonable minds could not come to a conclusion other than one favoring the movant."[73]

USTC raised three major objections to the district court's decision. USTC's primary argument was that its conduct was at most, "no more than isolated sporadic torts"[74] rather than antitrust violations. Further, USTC argued that Conwood failed to show sufficient foreclosure from the market for shelf space, and also that Conwood had not established a causal link between any of USTC's business practices and antitrust injury.[75]

With respect to USTC's argument that its practices were business torts as opposed to Sherman Act violations, the Sixth Circuit noted that although business torts alone are only violative of Sherman Act §2 in "gross cases,"[76] the fact that a business practice supports a tort cause of action does not prevent action under the antitrust laws if competitive injury has occurred. The key question for the court's analysis was whether or not "anticompetitive conduct" had occurred.[77]

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[73] Id.

[74] Id. at 783.

[75] Id. at 787 n.4.

[76] See 3A Areeda & Turner, Antitrust Law, P782(a), at 272.

[77] The court also held that the burden of proof would not be on Conwood to show with great detail the specific establishments at which the alleged behavior had taken place. The Court found Conwood's showing sufficient to support a conclusion that the acts were widespread.

The district court instructed the jury that "USTC could not be held liable for conduct that was part of the normal competitive process."[78] However, the court was clearly convinced that the nature of USTC's conduct was outside of that justifiable by the normal competitive process for distribution. USTC's claim that Conwood had failed to show sufficient foreclosure as required by the line of cases challenging exclusive dealing arrangements under Sherman Act §2 or Clayton Act §3 failed because the court distinguished the conduct in *Conwood* as unique due to USTC's position as category manager and the egregious nature of the product destruction allegations.[79] Specifically, the Sixth Circuit's analysis stated that "Conwood's claim is broader than merely challenging the exclusive arrangements USTC entered into with retailers for exclusive racks."[80] In this light, it seems that the Court found USTC's conduct especially suspicious due to USTC's relationship with retailers as the category manager. Specifically, the court points to evidence that "USTC used its position as category manager to exclude competition by suggesting that retailers carry fewer products, particularly competitor's products; by attempting to control the number of price

[78] Id. at 787 n.4. The Court attempts to distinguish USTC's behavior from that appearing in the line of exclusive dealing cases cited by USTC because of USTC's destruction of Conwood's racks and misrepresentations; all which the court clearly connects to USTC's position as category manager.

[79] Id.

[80] Id. at 787.

value brands introduced in stores; and by suggesting that stores carry its slower moving products instead of better selling competitor products."[81]

Finally, the court emphasized evidence of damages to Conwood. USTC argued that evidence showing an increase in the number of moist snuff brands during the 1990s, market expansion, an increase in Conwood market share and retailers' independent decisions not to display Conwood's rack and POS advertising were alternate causes of Conwood's injury.[82] However, the court was not persuaded by USTC's evidence, citing *Brooke Group* for the proposition that in the face of evidence indicating market expansion and competitive conditions, the ultimate issue is whether the market would have been even more competitive without the conduct at issue.[83]

Analyzing the facts in the light most favorable to Conwood, the court found that the jury's conclusion that competition suffered during the time period was reasonable. Based upon evidence from Conwood's expert, Dr. Leftwich, showing that a statistically significant relationship existed between Conwood's market share in those states where Conwood enjoyed a foothold and those in

[81] Id. at 787.

[82] Id. at 788.

[83] Id. at 789 (citing Brooke Group Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209, 225 (1993)).

which it did not, the jury agreed with the testimony and awarded damages within Leftwich's range of estimates varying between $313 and $488 million.[84]

Despite the Sixth Circuit's own recognition that courts rarely find antitrust liability on business torts alone, and the reaffirmation of that teaching in *Brooke Group*,[85] the decision stands as a warning to firms that antitrust liability may be substitutable for business tort liability in cases of product distribution. Whether or not the Sixth Circuit was correct with respect to its conclusion that competitive harm had occurred, an issue to be taken up in the next section, several points should be made regarding flaws in the analysis itself.

First, *Conwood* lowers the bar facing antitrust plaintiffs alleging competitive harm resulting from abuse of the category manager relationship. The economic analysis of category manager contracts discussed above suggests that category management is less restrictive than granting a manufacturer an exclusive right to the retailer's shelf space. It follows that the antitrust standard to be applied to category managers should be weaker than that applied to exclusive dealing contracts. However, the *Conwood* decision appears to place

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[84] Id. at 795. For a critical examination Dr. Leftwich's analysis and its flaws, see David Kaye, The Dynamics of Daubert Methodology, Conclusions, and Statistical Fit in Econometric Studies, 87 U. Va. L. Rev. 1933 (2001).

[85] Brooke Group Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209, 225 (1993). "Even an act of pure malice by one business competitor against another does not, without more, state a claim under the federal antitrust laws; those laws do not create a federal law of unfair competition or 'purport to afford remedies for all torts committed by or against persons in interstate commerce."

great weight on the fact that USTC's conduct was an "abuse" of its category management position. In fact, the Sixth Circuit specifically speaks of "the manner in which it used its position as a monopolist providing category management services, i.e. to exclude [competitors] from competition."[86]

A separate analytical flaw is that *Conwood* does away with the requirement of a showing of substantial foreclosure. There is no doubt that a category management arrangement, like an exclusive dealing contract, may produce an anticompetitive result under certain conditions. As discussed above, monopolization law generally, and exclusive dealing analysis specifically, require a showing of anticompetitive effect as a prerequisite for antitrust liability. *Conwood* forgoes the accepted analysis of allegedly exclusionary agreements. This flaw is especially suspicious because it is likely that the application of this accepted analysis, incorporating substantial foreclosure, would have changed the result in *Conwood* as the evidence is scant on the issue of substantial foreclosure of a critical resource, a predicate factual finding of anticompetitive effect.

Third, *Conwood* emphasizes the possible link between a manufacturers' position as category manager and the product destruction that took place.[87] There is no doubt that *Conwood* differs from traditional monopolization cases as a

[86] Id. at 787.

[87] Id. at 787 n.4.

result of the product destruction element of the antitrust claims. However, the suggestion that a systematic link exists between category management and product destruction is not supported. To the contrary, the analysis in Section 4 suggests that a self-enforcing mechanism whereby a retailer could terminate a manager abusing its position would protect retailers against such abuses of the category manager designation.

One question that might be raised by the *Conwood* decision is whether or not accepted antitrust analysis in monopolization cases analyzing the percentage of the market foreclosed, entry conditions, duration of contract and other competitive conditions is properly applicable to cases where the conduct involves instances of egregious conduct such as product destruction, which does not have any offsetting price or quality benefits, nor efficiency enhancing properties. From an economic standpoint, the crucial question is whether or not the defendant's conduct, whether it falls inside or outside any court-made boundaries of "meritorious" competition, is sufficient to exclude rivals. The economic analysis of that conduct is not dependent on the court-perceived merit of the conduct where both parties have access to the competitive process. Product destruction cases, then, seem to fall within the more general framework of exclusionary analysis without modification. Therefore, the argument that a different standard should be applied to product destruction cases is not

persuasive.[88] Perhaps *Conwood's* emphasis of product destruction will ultimately limit the application of its flawed analysis to cases including equally egregious allegations. However, no such limitation currently exists in an area of law where guiding precedent is particularly scarce.

5.4. USTC's Conduct Was Unlikely to Cause Any Anticompetitive Effect

The economic analysis of category management suggests that category management is a method used by manufacturers and retailers to facilitate contracts governing the retailer's supply of promotional effort. This analysis has nothing to do with the anticompetitive foreclosure of rivals. However, a manufacturer may be able to increase barriers to entry and exclude rivals by prohibiting them from access to shelf space sufficient to compete at minimum efficient scale, thereby increasing its own market power under certain conditions.

Unfortunately, the Sixth Circuit did not engage in a full analysis of the likelihood of competitive harm. The truncated analysis appears to be linked to USTC's position as a category manager and its egregious conduct, including product destruction and deception. When combined with the weak evidence of anticompetitive impact submitted by Dr. Leftwich, sufficient evidence was found to support a finding of antitrust liability. However, the necessary conditions for

[88] Additionally, the ability of the plaintiff to seek business tort remedies militates against any argument for changing the standard.

such an exclusionary strategy to result in anticompetitive impact are sufficient to assess anticompetitive effect without reliance on subjective notions of the severity, or irregularity of USTC's conduct relative to the normal competitive process.

Category captains are typically firms with significant market share in the industry.[89] Under certain conditions, a dominant firm may be able to engage in behavior that excludes rivals and also injures competition. Specifically, a dominant manufacturer may foreclose competing manufacturers and potential entrants by tying up a sufficient mass of a critical input through contractual arrangements such that the manufacturer or potential entrant is unable to achieve minimum efficient scale. Therefore, the monopolization analysis is identical to that of a dominant firm entering into exclusive agreements with retailers or other distributors.

First, market power is a necessary condition for competitive harm to occur. Market power was not a disputed fact in the case as USTC had approximated 77% of the moist snuff sales in the national market.[90]

Second, the dominant firm must sufficiently foreclose shelf-space or access to product distribution in order for antitrust injury to occur. In this case, both the

[89] FTC Report at 51.

[90] 290 F.3d at 774.

district court and the Sixth Circuit eschewed such analysis in favor of anecdotal evidence of the widespread impact of USTC's more egregious rack-destroying and misleading behavior. However, USTC did present evidence that less than 10% of all stores carried USTC racks exclusively.[91] Additionally, USTC presented evidence that Conwood was in 81% of all retail stores offering moist snuff products.[92] Availability in 81% of the relevant retail stores suggests that Conwood was not sufficiently foreclosed such that it could not achieve minimum efficient scale.

There was also evidence that a USTC discount program for retailers granting USTC preferred space on the shelves and participating in USTC promotions was able to sign 37,000 retailers, representing 80% of the moist snuff sales.[93] The evidence does not show that Conwood was unable to offer similar discounts to retailers, nor that Conwood was foreclosed from obtaining shelf space for its own products. To the contrary, evidence presented by USTC indicates that in some stores offering exclusivity to USTC, such as Wal-Mart, Conwood failed to participate in the plan-o-gram competition offered by the retailer.[94] Therefore, while the record is unclear as to the exact percentage of

[91] Id. at 775.

[92] Petition for Writ of Certiorari, at 19.

[93] Id. at 778.

[94] Id. at 775 n1.

shelf space foreclosed by USTC exclusive rack situations, the 10 percent presented by USTC and undisputed by Conwood is far less than the requisite foreclosure percentage in Sherman Act Section 2 and Clayton Act Section 3 cases. However, the 10 percent figure only symbolizes the level of foreclosure resulting from USTC's contractual arrangement. This does not tell the entire story.

The 10 percent foreclosure figure does not account for USTC's product destruction and removal. The relevant antitrust question is whether USTC's conduct, contractual and otherwise, was sufficient to prohibit Conwood from operating at minimum efficient scale. To the extent that USTC's product destruction tactics and deception foreclosed Conwood's ability to distribute product, that foreclosure should also be included in the analysis.

Evidence suggests that Conwood's costs were increased by up to $100,000 a month in replacing product.[95] The procedural stance of the case required the court to construe the evidence in the light most favorable to Conwood because this claim of $100,000 monthly for replaced racks went unchallenged at trial by USTC.[96] There is very little evidence supporting or refuting a conclusion that that this $100,000 monthly figure was sufficient to raise Conwood's costs to a level that they could not operate at minimum efficient scale. The figure

[95] 290 F.3d at 778. Conwood's Chairman, William Rosson, testified that about 50% of the sales representatives' staff time was spend repairing destroyed racks. Id.

[96] Id. at 785.

apparently represents about 20,000 racks per month. The important analytical point is that the economic analysis of competitive harm for typical monopolization cases is well-suited to this analysis and substitution towards a less sophisticated framework is not necessary when cases involve allegations of product destruction or other tortious behavior.[97]

Third, economies of scale or scope at the manufacturing level are a necessary condition for competitive harm. USTC argued that its goal in attempting to increase distribution of its product was to take advantage of scale economies in the manufacture of moist snuff tobacco.[98] While this is a mild concession by USTC, it is unclear how important scale economies are to moist snuff manufacture from the record. The key economic question is the degree to which a decrease in quantity supplied by Conwood would increase Conwood's costs. Without economies of scale, a reduction in scale would not increase Conwood's variable costs and therefore would leave rivals' abilities to discipline USTC's attempts to price increases unaffected.

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[97] Conflating elements of the tortious conduct into antitrust analysis does prove problematic in some respects. For example, without application of traditional monopolization analysis, tortious conduct such as destruction of a manufacturer's plant by a dominant manufacturer would become an antitrust violation. Clearly, regulation of such conduct is better handled by tort law and access to the prospect of punitive damages.

[98] Id. at 787 n.4.

Finally, although entry conditions at the retail level were scarcely analyzed by the district court or the Sixth Circuit, it is an important economic point that competitive harm may not occur if entry at the retail level is easy. Without barriers to entry at the retail level, disadvantaged suppliers may realign supply contracts with new entrants. Because the distribution level in *Conwood* consists primarily of grocery retailers, and includes stores like Wal-Mart and gas stations, it is highly unlikely that any significant barriers to entry exist. Retail is an intensely competitive industry in the United States with very thin margins and intense price and non-price competition.[99]

While entry is not necessarily instantaneous, the amount of shelf space foreclosed is obviously a decreasing function of the ease of entry. Any attempt to foreclose a sufficient amount of shelf space to make the supply of such space profitable through entry into the market will increase the amount of shelf space in the market and therefore decrease the percentage foreclosed. If entry conditions were not difficult, the likelihood that USTC's conduct caused competitive harm is low.

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[99] See Joshua Wright, Von's Grocery and the Concentration-Price Relationship in Grocery Retail, 48 UCLA L. REV. 743 (2001); Keith B. Anderson, Structure-Performance Studies of Grocery Retailing: A Review in COMPETITIVE STRATEGY AND ANALYSIS IN THE FOOD SYSTEM 203-212. *But see*, Ronald W. Cotterill, Market Power in the Retail Food Industry: Evidence from Vermont, 68 REV. ECON. & STAT. 379 (1986); Frederick E. Geithman, et. al, Concentration, Price, and Critical Concentration Ratios, 63 REV. ECON. & STAT. 346 (1981); R. McFall Lamm, Prices and Concentration in the Food Retailing Industry, 30 J. INDUS. ECON. 67 (1981).

As the court in *Brown & Williamson Tobacco Corp*. stated, "Even an act of pure malice by one business competitor against another does not, without more, state a claim under the federal antitrust laws."[100] In *Nynex v. Discon*, the Court held that "other laws, for example, 'unfair competition; laws, business tort laws, or regulatory laws, provide remedies for various 'competitive practices thought to be offensive to proper standards of business morality.'"[101] It appears that rather than engage in the complex analysis of the monopolization framework that has been applied to exclusionary conduct cases, the Sixth Circuit assumed that the conduct of USTC was widespread enough to make such an analysis moot, or perhaps that the non-meritorious conduct of USTC made such an analysis extraneous.

6. Conclusion

United States Tobacco faces a $1.05 billion verdict stemming from, among other things, abuse of its category manager position. As alluded to earlier, USTC was found guilty of a Sherman Act § 2 monopolization violation because of its conduct in the moist snuff tobacco market, including unauthorized removal and destruction of competitors' display racks and product. While *Conwood* stands as the seminal antitrust decision applying monopolization law to category manager

[100] 505 U.S. 209, 225 (1993). See David Balto, The 'Conwood' Decision, National Law Journal (Aug. 19, 2002).

[101] 525 U.S. 128, 137 (1998).

conduct, the egregious behavior involved limits its usefulness as a guideline for understanding the general application of monopolization doctrine to cases involving category manager.

Category management involves a retailer designating a particular manufacturer as "category captain" or "category manager." The role of the category manager is to provide the retailer with input regarding the retailers' shelf space allocation decision and product assortment. The fundamental economic question addressed by this paper is: "why would a retailer shift control over the shelf space allocation decision to a manufacturer?" Arrival at a proper answer to that question requires an understanding of the economics forces at work in distribution contracts involving promotional effort generally, and more specifically, shelf space. Understanding the economics of category management is not only important from an economic theory perspective, but also in terms of the antitrust standard to be applied when a dominant manufacturer designated category manager becomes a defendant to a monopolization claim.

Manufacturers have the incentive to subsidize dealer promotional effort, such as the provision of featured shelf space, in order to induce impulse sales. In other words, provision of shelf space raises the reservation values of particular consumers that are sensitive to shelf space allocation. Manufacturers with high margins of wholesale price to marginal cost have the greatest incentive to

subsidize dealer promotion inducing incremental sales. Because retailers are unlikely to provide the jointly profit-maximizing level of shelf space without compensation, manufacturers must compensate retailers for the provision of promotional shelf space. Manufacturer compensation of dealers can occur with per unit time payments such as slotting fees, or a per unit sale payment such as a reduction in the wholesale price. Manufacturer compensation creates an incentive for the retailer to cheat on the contractual arrangement by taking the payments and promoting rival products with higher margins.

Exclusive dealing is one method by which manufacturers can reduce the retailer's incentive to promote rival products. Likewise, granting a manufacturer an exclusive right to shelf space also increases the value of the shelf space and the level of payments a retailer can demand for exclusive promotion. However, exclusivity is not costless to the retailer. Specifically, granting a manufacturer an exclusive right is costly to the retailer in terms of decreases its ability to satisfy consumer demand for product variety. Therefore, one does not expect to observe exclusive dealing where consumer demand for product variety is high.

Category management serves as a less restrictive alternative to exclusive dealing as a means of reducing a retailer's incentive to promote rival products. Where consumer demand for product variety is high, granting an exclusive may be prohibitively costly and granting a manufacturer category manager status

provides the retailer the best of both worlds. The retailer can extract payments from the manufacturer for the provision of "extra" shelf space associated with the right to control the shelf space; on the other hand the retailer can minimize the costs associated with reduced product variety. This explanation of category manager contracts provides an efficiency rationale for the practice and has nothing to do with raising rivals' costs or exclusion of rivals.

Conwood stands as the seminal case addressing the antitrust standards applied to category managers alleged to have abused their designation to exclude rivals from access to shelf space.[102] The decision sounds a warning shot above the heads of dominant firms contemplating offering category management services to retailers as it appears to impose greater duties on category managers than even those manufacturers granted an exclusive right to shelf space.

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[102] The decision in El Aguila Food Products, *supra* note 57, included allegations that Gruma monopolized tortilla manufacture primarily through the use of slotting fees and other promotional activity, but also with category management practices. 2003 U.S. Dist. at *54. The court held that plaintiffs' Section 1 and 2 claims failed because plaintiffs had not sustained their burden on summary judgment to show adverse effect on competition, and that Gruma had market power. Id. Because plaintiff failed to show that Gruma had market power or that its practices had adversely impacted competition, the court did not specifically address, and did not need to, how Gruma's role as category manager might have caused such harm. The recent decision in R.J. Reynolds Tobacco Co. v. Philip Morris Inc., 199 F. Supp. 2d 362 (M.D. N.C. 2002), involved Philip Morris' "Retail Leaders" program granting discounts to consumers and making promotional payments to retailers in exchange for favorable display and promotional space within retailers' stores. Philip Morris generally obtained cigarette product space in an amount equal or less than its market share. Where Philip Morris' local market share exceeds 55%, Philip Morris contractually required only 90% of its share of product space. Id. at 370. Contracting for a large degree of shelf space while allowing the retailer to retain a sufficient level of shelf space to satisfy consumer demand for variety is an alternative to granting a category manager contract. However, *RJR* does not specifically address standards to be applied where a dominant manufacturer is a category manager.

Imposing greater duties on category managers is perverse to the economic explanation for designating category managers in this paper, that category management is a less restrictive method of facilitating the distribution contract than exclusive dealing.

Conwood also stands alongside *Microsoft* as representing an emerging trend towards application of a weaker evidentiary standard with respect to the showing of anticompetitive effect where a court made determination is made that competition is not "on the merits." In *Microsoft*, the anticompetitive effect requirement was foregone upon a court-made determination that competition was not "on the merits." In *Conwood*, the rigorous economic analysis associated with modern antitrust cases was eschewed in favor assuming liability based upon the atmospherics of USTC's conduct as well as weak evidence of damages to Conwood.[103] The argument that a different standard is justified in *Conwood* because of the egregious allegations of product destruction is not persuasive. Economic analysis of exclusionary distribution contracts requires a determination of whether or not the reduction in scale caused by defendants' conduct raised the costs of the rival sufficiently to decrease its ability to

[103] See Herbert Hovenkamp, Book Review: The Rationalization of Antitrust, Antitrust Law by Richard A. Posner (2d ed. 2001), 116 Harv. L. Rev. 917, n. 135 (2003) (criticizing Conwood's expert for inventing "new and previously untested procedures" and applying a simple regression attributing all of Conwood's lack of growth in markets where USTC competed to anticompetitive practices without exploring alternative explanations.).

discipline attempted price increases by the dominant firm. Product destruction is no different. Economic analysis of raising rivals' costs claims is sufficient to address product destruction cases without altering the legal standard applied.

Conwood presents an opportunity to allow USTC's extreme conduct to cloud the understanding of the economics involved in typical category manager contracts. It is an opportunity that should not be taken. The analysis of category management presented here suggests that manufacturers and retailers utilize category management as an alternative to exclusive dealing as mechanism for ensuring enforcement of contracts for product promotion. One would expect that such a self-enforcing contractual arrangement, not to mention business tort liability, would protect retailers from the type of conduct at issue in *Conwood*.

This paper provides a first step in the analysis of category manager contracts. This article suggests that category management is a less restrictive means of facilitating promotional contracts, and thereby, a method to increase the value of the shelf space offered to manufacturers by retailers while minimizing costs associated with loss of product variety.

Antitrust commentators have recently highlighted the importance of the anticompetitive effect requirement in preventing antitrust law from chilling competitive conduct that may not be understood.[104] This paper provides an

[104] Timothy J. Muris, The FTC and The Law of Monopolization, 67 ANTITRUST L. J. 693 (2000).

efficiency justification for category management distribution contracts and helps to shed light on the role of this increasingly frequent practice in the normal competitive process. The increased frequency of category management suggests that most manufacturers designated as category managers are in fact performing in a manner consistent with the implicit understanding of the contractual arrangement between the parties.

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