

5

Agreements Between Suppliers and Customers

The previous chapters have dealt with aspects of agreements between companies at the same level of production or distribution. This chapter begins the transition to issues involving agreements, formal or informal, between companies at different distribution levels, and examines potential antitrust issues that can arise from restrictions in agreements between buyers and their suppliers.

After a brief overview, this chapter examines exclusive agreements, which can range from absolute “air-tight” exclusivity (where, for example, there is only a single distributor of the product, or where an upstream supplier enters into an exclusive supply agreement with one buyer), to arrangements that are not absolute—such as appointing a single distributor for a particular industry or geography/territory—to exclusive dealing in which a distributor agrees to carry only the products of a single supplier. The discussion continues with an examination of other vertical agreements, such as “most-favored nation” clauses, reciprocity, and resale price maintenance, before finishing with a look at some of

the significantly more restrictive approaches that important jurisdictions outside the United States continue to take with respect to vertical agreements.

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Vertical Agreements

Generally

Q 5.1 What is a vertical agreement?

A vertical agreement is one between entities at different levels of the distribution chain. When firms at different levels of the distribution chain agree to restrictions affecting the purchase or sale of a product, they enter a vertical agreement.

Q 5.1.1 What federal antitrust statutes potentially apply to vertical agreements?

Vertical agreements are typically analyzed under section 1 of the Sherman Act, which prohibits agreements, combinations, or conspiracies in restraint of trade. The discussion below focuses on this framework. Plaintiffs may also use section 2 of the Sherman Act to challenge restrictive distribution practices, though this is rare because the standard for liability under section 1 is easier to satisfy. In addition, exclusive

dealing and tying may also be challenged under section 3 of the Clayton Act, but the standards for liability under that statute are essentially the same as under section 1 of the Sherman Act. Finally, the FTC could use section 5 of the FTC Act to challenge practices that fall short of violating the Sherman Act, but neither the FTC nor DOJ has shown much interest in challenging vertical practices in the modern era.

Antitrust Analysis of Vertical Agreements

Q 5.2 As a general matter, how are restrictions in vertical agreements analyzed?

Antitrust law in the United States stresses the importance of inter-brand competition between suppliers and presumes generally that vertical agreements that limit competition in the distribution of one supplier's own product (so-called intra-brand competition) are designed to enhance, not reduce inter-brand competition. Antitrust law also recognizes that distributor welfare is not necessarily synonymous with consumer welfare: Because wholesalers and retailers may have economic interests that are not necessarily consistent with those of their own customers, their complaints about restrictions may reflect their own interests and may not indicate anything about the restrictions' potential effect on consumers or competition. Thus, absent significant power in its own market, neither a supplier's restrictions on a customer's or distributor's purchase or resale of its products, nor a customer's restrictions on a supplier's sale of products, is likely to raise any significant antitrust concerns.

Q 5.2.1 Has U.S. antitrust law always been so permissive with respect to vertical restrictions?

No. The older antitrust approach to vertical restraints was premised on the early common law's condemnation of restrictions on alienation imposed on purchasers of a good. In the late nineteenth and early twentieth centuries, and within the early populist framework of the Sherman Act, this concern about alienation became a broader rhetorical condemnation of agreements that infringed upon the commercial independence and liberty of retailers. It was unthinkable to some courts and commentators that retailers would ever voluntarily agree to restrictions on their own ability to trade as they like. Thus,

ANTITRUST LAW FACT

The Changing Treatment of Vertical Restraints

The older antitrust approach to vertical restrictions assumed their use was due to the greater market power that suppliers had over customers. There generally are fewer manufacturers than retail outlets, and in the early days of the Sherman Act, retailers looked a lot more like Mayberry's store owners than Wal-Mart, Target, or, for that matter, Tesco, Carrefour, and Aldi. As a result, early Sherman Act jurisprudence was far less tolerant of the range of vertical restrictions that suppliers imposed upon purchasers, including resale price maintenance, exclusive dealing, exclusive territories, and the required purchase of multiple products (often referred to as tying or bundling).

Fortunately, things changed. Nowhere was the revolution in antitrust law of the 1970s and 1980s felt more strongly than in the area of non-price vertical restrictions. Many vertical practices were condemned as per se illegal during the 1960s; by the end of the 1980s, only resale price maintenance and tying by dominant firms remained potentially per se illegal. Today, not even resale price maintenance remains per se illegal (at least under federal antitrust law), although that issue is often the subject of pending Congressional legislation. Tying by dominant firms in some cases theoretically could be per se illegal, but those cases are more likely to be discussed on university blackboards than in federal courtrooms.

For the federal antitrust agencies, vertical issues have all but disappeared from the enforcement agenda. They remain a much greater concern to state antitrust enforcers, some of whom still actively pursue vertical price-fixing/resale price maintenance cases. The primary antitrust risk from vertical agreements, however, remains private challenges, often brought by terminated or otherwise disgruntled distributors that attempt to use antitrust claims as leverage in commercial disputes.

contracts containing these provisions were assumed to be the result of coercion (even if the supplier had a relatively small share of an upstream market), and thus undesirable.

Today, the Sherman Act focuses less on preserving dealer independence and more on protecting consumer welfare. As noted at the end of this chapter, other jurisdictions take a different view. Unless restrictions on dealers are likely to have anticompetitive effects on consumers, challenges to them are not likely to succeed. Nevertheless, economists recognize that certain restrictions imposed by leading suppliers in particular contexts could raise significant risks of harm to consumer welfare. Dominant firms can impose terms on dealers or manufacturers of complementary products that make entry more costly, time-consuming, and inefficient than in the absence of such restrictions. Even in those contexts, however, restrictions might not have a significant exclusionary impact, and even if they do, there might be pro-competitive justifications for the restrictions.

Q 5.3 How does a court or agency analyze vertical agreements?

Vertical arrangements are today virtually always analyzed under the rule of reason. Before a court can determine whether competition is harmed by a vertical agreement, it will first assess whether the party seeking to impose the restriction has market power in a relevant market affected by the restriction.

Q 5.3.1 How does one determine whether the supplier has market power?

The first step in rule-of-reason analysis is to define the relevant product and geographic market affected by the restriction. In the context of restrictions on dealers, the relevant market is likely to be the supplier's universe of products, whether the products are shampoos, automobiles, HDTVs, or microprocessors. After defining a relevant product and geographic market, the next step is to determine the supplier's percentage share of the market (either sales or revenues) and the percentage of downstream outlets affected by the restriction. In most cases, there is not likely to be any antitrust problem if either

number falls below 35%. For counseling purposes, it is prudent to be conservative in how the markets affected by the restraints are defined and measured.

Q 5.3.2 What happens if the supplier is found *not* to have market power?

If the rule-of-reason analysis determines that the party seeking to impose the restriction does not have market power in a relevant market affected by the restriction, generally that is the end of the inquiry.

Q 5.3.3 What if the supplier is found to have market power?

If there is market power, the court will then evaluate the impact of the restriction on competition in the relevant market or markets to determine if competition has been harmed. Today, the analysis is the same whether the restriction at issue involves price directly, or non-price terms such as territorial restrictions or exclusivity.

Q 5.4 How does a court determine if competition has been harmed by a vertical agreement?

There are various factors a court may consider as it balances the potential for anticompetitive harm against the pro-competitive benefits of a vertical agreement, including:

- the nature and extent of possible foreclosure of the market;
- the duration of the agreement;
- the importance of the input to downstream competition;
- the impact (if any) of potential entry in the upstream market;
- evidence of actual effects in the downstream market; and
- the extent of other exclusive supply agreements between buyers and upstream suppliers.

Q 5.4.1 What is the significance of the nature and extent of foreclosure?

The term “foreclosure” means the extent to which a vertical agreement may prevent (or foreclose) competing buyers or suppliers from

being able to obtain the products or retail/distribution services subject to the vertical agreement.

Quantitative measures are often used to demonstrate that the extent of foreclosure is not likely to be significant. For example, in evaluating an exclusive supply agreement, the most relevant quantitative measure is the market share of the upstream supplier (or suppliers) with whom the downstream customer has exclusive arrangements. As a general matter, exclusive arrangements representing less than 35% to 40% of the upstream market will not give rise to inferences of quantitatively significant foreclosure, regardless of the duration of the contract.

When conducting a risk assessment using these quantitative guideposts, the upstream market should be defined narrowly, even if it seems unlikely that a court would define the market so narrowly. For example, a widget manufacturer seeking an exclusive supply agreement for titanium that can be used in high-performance widgets should assume that the relevant input market is for titanium, not any and all metals that might be used as a substitute for titanium in widgets, or even in high-performance widgets. That gives a conservative result, which enables the widget manufacturer to focus on other competitively significant factors.

Although low percentages of foreclosure may suggest that anti-competitive effects are unlikely, high percentages of foreclosure do not necessarily mean that anticompetitive effects are likely. As discussed in further detail below, the terms and duration of the vertical agreement, the structural characteristics of the relevant market, and the justifications for the agreement may show that the agreement is not likely to be anticompetitive. (See also Q 5.12 for a discussion of the role played by the use of exclusive supply contracts by other competitors in assessing the extent of foreclosure.)

Q 5.4.2 ... of the duration of the agreement?

Generally speaking, the shorter the agreement is or the easier it is to terminate, the more likely the agreement is to be upheld. Longer agreements may receive more scrutiny, but they are not necessarily condemned by their length if the overall effect on competition is minimal. If an agreement is short (less than a year) or easy to terminate

(for example, terminable within a year), it is unlikely to have lasting anticompetitive effects unless it covers a significant portion of the upstream product market. In fact, even a longer agreement covering a significant portion of the upstream market (or a series of agreements involving a single purchaser with multiple suppliers) is likely to pass antitrust muster if termination is relatively easy. Termination, however, must be a feasible alternative. If the supplier must pay a penalty for termination, or if the contract on its face involves so much additional consideration that abandonment is unlikely, then terminability becomes a less viable defense. In other words, termination must be sufficiently easy to suggest that the contract is not coercive, and it must be sufficiently attractive to suggest that the contract is not designed to split profits from higher prices in the downstream market that could result from exclusivity.

Q 5.4.3 ... of the importance of the input to downstream competition?

If supply is not completely foreclosed by an agreement and the most likely theory for a challenge is that exclusivity raises a rival's input costs, then anticompetitive effects are likely only if the input is a significant portion of the cost of producing the downstream product. Doubling, tripling, or even quadrupling the input cost for a rival is not likely to have a significant competitive effect if the input represents only 0.1% of the cost of production. It is therefore useful to understand the economic significance of an input in determining whether exclusivity is likely to have a significant competitive effect.

Q 5.4.4 ... of the impact of potential entry in the upstream market?

The overall ease or difficulty with which a new supplier could enter the upstream market should also be considered. Exclusivity may make entry attractive for potential new suppliers by removing a significant upstream competitor from the merchant market serving other downstream customers. Entry under these circumstances, of course, must be more than theoretical to ensure that exclusivity is not likely to have anticompetitive effects. Firms can behave opportunistically and anticompetitively for short periods of time if they are certain that entry will not be soon enough or significant enough to prevent them from taking price increases.

**CASE STUDY: *FTC v. Mylan Labs., Inc.*¹**

In the pharmaceutical sector, the FTC challenged exclusive agreements between Mylan Pharmaceuticals and its raw materials suppliers that allegedly enabled Mylan to take significant price increases on three different generic drugs. Although entry by new suppliers might have been possible within one or two years of the exclusive agreements being signed, competing generic firms were unable to obtain the raw materials from alternative sources immediately because of FDA regulations. As a result, the possibility of eventual entry was allegedly not sufficient to prevent Mylan from taking significant price increases. After the district court upheld the FTC's authority to seek disgorgement and restitution for such antitrust violations, Mylan settled the case by agreeing to pay \$100 million to purchasers of its drugs.

Q 5.4.5 ... of evidence of actual effects in the downstream market?

In the final analysis, the most direct evidence of the impact of exclusive agreements is price effects. When a purchaser obtains a significant exclusive supply agreement and then raises the price of its downstream product, courts and enforcement agencies are likely to infer that the agreement led the purchaser to believe that its competitors would not be able to obtain sufficient or comparably priced inputs to deter the price increase.

As a practical matter, rarely will companies have the luxury of knowing in advance what will happen as a result of an exclusive agreement; instead, counsel will be asked to provide advice on what is *likely* to happen. Occasionally executives for a buyer may discuss what they intend to do with their exclusive agreement over time—increase production, reduce prices, or perhaps increase prices down the road. Obviously, counseling the supplier in these agreements becomes more complicated, as it may not have any insight into the purchaser's pricing plans for downstream products. But the purchaser's businesspeople

might have some insight based on the consideration they are able to obtain in exchange for exclusivity—any significant above-market premium paid for the input could reflect an anticipated split of future increases in downstream profits, which may raise red flags.

Q 5.5 How does a party considering a vertical agreement determine whether the restriction at issue is likely to result in anticompetitive effects?

The primary anticompetitive effect of restrictions on purchasers is foreclosure of competing sellers, usually measured in quantitative terms. But that must then translate into a reduction of competition below levels that would have existed in the absence of the restrictions and then into adverse effects on consumers. If a supplier's restrictive practices prevented equally or more efficient rivals from competing or emerging in the supplier's market, then the practices may well have an anticompetitive effect.

As discussed in earlier chapters, proving causation is a lot more important and complicated than many outside the antitrust world may guess. If competitors were less efficient, less aggressive, or simply unlucky, then it is less likely that the restrictive practices made any difference. Courts have become reluctant to transform corporate deaths into antitrust murder cases. Nevertheless, exclusive agreements followed by declining shares of smaller firms and increasing prices from the supplier in question can raise antitrust red flags for firms with significant market positions.

Q 5.6 How does a party considering a vertical agreement analyze pro-competitive effects if anticompetitive effects are possible or likely?

Potential justifications include raising incentives for investments, protecting intellectual property, or eliminating free riding (the ability of other competitors to benefit from investments in marketing or service that they did not make). As a practical matter, courts are likely to take those justifications more seriously if they are reflected in contemporaneous documents, make economic sense, and are not contradicted by other statements or actions suggesting that the justifications are pretextual.

Dual-Distribution Arrangements

Q 5.7 What is dual distribution?

Dual distribution describes those situations where manufacturers themselves operate as distributors in actual or potential competition with their independent distributors. If a manufacturer directly distributes its product using both company-owned stores and independent distributors, it engages in dual distribution. (See also Q 5.28.)

Q 5.7.1 Are dual-distribution situations transformed into per se unlawful horizontal agreements?

In dual-distribution situations, manufacturer-imposed restrictions on their independent distributors, such as limitations on the geographic areas or customers they can serve, might be attacked as per se unlawful horizontal agreements because of the competition between the manufacturer and the distributor in selling to end users. Some pre-1980 lower court cases did analyze non-price restrictions in dual-distribution situations as per se unlawful horizontal agreements; however, this approach has been rejected in more recent cases. Today, territorial, customer, and other restrictions that are established in a dual-distribution setting are generally deemed vertical and, therefore, subject to a rule-of-reason analysis. The rationales behind these decisions are that the manufacturer acted alone in imposing the restriction; the restraint is similar to those adopted by manufacturers that are not engaged in dual distribution; or the distributor can compete only because of goods supplied by the manufacturer, which highlights the vertical nature of the relationship.

Exclusive Agreements

General Considerations

Q 5.8 Is a written contract required for a contract to be considered exclusive?

No. There does have to be an agreement between the supplier and the buyer, but as in other areas of antitrust, the agreement need not be an explicit, written one. Factual circumstances can be used to infer an exclusive agreement.

Loyalty or tiered pricing discounts that create strong incentives for the supplier to sell only to a particular buyer may create de facto exclusivity. For example, if a contract contains pricing provisions that punish a seller that deals with another downstream purchaser, the contract may be found to be an implicitly exclusive contract. However, even in cases of de facto exclusivity where a seller is dealing with only a single downstream customer, there must still be an actual bilateral agreement between the buyer and the supplier. If the supplier has the practical freedom to sell products to other buyers, but elects unilaterally to sell only to a single buyer, there is no exclusive supply agreement. Such a determination often involves looking beyond the written agreement and surrounding negotiations to facts regarding the nature of the relationship between the parties and whether the option to sell to other buyers truly exists.

As a practical matter, if a plaintiff alleges an exclusive supply agreement resulting from an informal understanding, it will be extremely difficult for the plaintiff to show that an unenforceable contract will prevent the supplier from offering its products to other downstream purchasers willing and able to pay for them.

Q 5.9 How do justifications for exclusivity affect the antitrust analysis of such provisions?

As a practical matter, most exclusive contracts do not raise significant antitrust issues because they do not foreclose a significant portion of an upstream market or involve a large portion of downstream product cost, or they permit termination with short notice and without penalty. But there may be rare cases where a business has entered into a long-term, exclusive supply contract where the supplier is not likely to be able or willing to walk away. In such cases, it is useful for a purchaser to understand and articulate why exclusivity is necessary for the agreement. If the purchaser proceeds with exclusivity, then it is useful to articulate the pro-competitive reasons for doing so.

By understanding the reasons for exclusivity where antitrust risks may be more significant, it may be possible to identify alternative methods of achieving the same objective. For example, if the business

is concerned about protecting its intellectual property, it may be possible to grant only a limited-use license. If concerns nevertheless persist, then perhaps the supplier will agree that any employees collaborating with your business will not work with your competitors. Exclusivity may well be the efficient solution to the perceived problem, but if a less restrictive alternative is available, it could reduce the antitrust risk while still meeting the business objective.

Q 5.10 Is there any sort of “safe harbor” in which exclusive agreements do not pose any antitrust problems?

There is no safe harbor, but courts have routinely upheld vertical agreements that foreclose less than 20% of the market. Foreclosure of a higher percentage of the market does not automatically condemn an agreement.

Exclusive Supply Agreements

Q 5.11 What are the most important considerations for a purchaser regarding exclusive supply agreements?

As a general matter, when it comes to dealing with exclusive supply agreements, a purchaser should do the following:

1. Have a process for becoming aware of exclusive supply agreements; identify and review any exclusive supply agreements.
2. Look at the terms of the agreement: duration, terminability, liquidated damages provisions, and the nature and magnitude of consideration.
3. Determine the significance of the input as a portion of downstream product costs, the position of the upstream supplier in the relevant market, and the reasons for entering this agreement.
4. If the agreement involves a significant portion of the upstream market, get more information about the position of other input suppliers and the anticipated impact of the agreement (through brief employee interviews and document review).

5. Explore alternative methods of achieving the same objectives.
6. If it is determined that there are significant risks but it is believed there are no alternative methods of achieving the objectives, and the company insists on going forward, ensure all pro-competitive reasons for proceeding are memorialized and ensure that it is understood that entering into similar additional contracts with other suppliers may raise greater risks down the road.

Q 5.12 What role does the use of exclusive supply agreements by other competitors on an industry-wide basis play in the antitrust analysis of a particular agreement?

In assessing the extent of foreclosure, a court or enforcer will look at the entire relevant upstream market, which may include accounting for other exclusive agreements within the market (some courts believe this is irrelevant). If every potential supplier is “tied up” with an exclusive agreement from which a buyer either cannot or is unlikely to depart, the practical effect of an individual agreement may be more extensive than just the portion of the upstream market subject to the agreement being challenged. Industry-wide use of vertical practices also may trigger inquiry into whether the practice is really being used to implement a horizontal conspiracy.

Q 5.13 How can a series of bilateral exclusive supply agreements negotiated by a single customer raise antitrust risks?

A series of exclusive supply agreements negotiated by a single customer, especially one with market power, can give rise to the perception of a horizontal hub-and-spoke conspiracy with multiple suppliers. These kinds of scenarios are obviously the exception, not the rule, but they underscore the importance of ensuring that individual agreements are not occurring against a broader backdrop that could raise significant risks for a business.

**CASE STUDY: *Toys “R” Us, Inc. v. FTC*²**

Facing challenges to its specialty retail model from “category-killer” retailers like Wal-Mart, Sam’s Club, and Costco, Toys “R” Us allegedly went to leading toy manufacturers and obtained preferential pricing and allocations of popular toys, putting non-specialized retailers at a competitive disadvantage. Toys “R” Us purportedly threatened to retaliate against manufacturers that did not comply and also pointed to other manufacturers that had allegedly agreed to provide Toys “R” Us preferential access in attempting to persuade more stubborn suppliers to join the movement. The FTC held, and the Seventh Circuit agreed, that Toys “R” Us had gone beyond mere persuasion and not only had entered agreements with a number of individual toymakers, but also had orchestrated an understanding among leading toy manufacturers themselves to put club stores at a disadvantage.

Q 5.14 Can a purchaser seeking an exclusive supply agreement request that one of its suppliers terminate any relationships the supplier has with one or all of the purchaser’s competitors?

Maybe, as long as such a choice is a voluntary one and not imposed upon the supplier (either because of the purchaser’s buying power or due to threats of termination). Such an arrangement should have reasonable limits on the reach of the exclusivity depending on the business goals and pro-competitive benefits the purchaser wishes to achieve. If the agreement is a result of coercion or because the purchaser’s market power is such that the supplier feels it has no choice but to enter into the agreement, the agreement could be perceived as anticompetitive. In reality, however, such an agreement is not likely to have a significant effect unless the supplier itself has market power.

Q 5.15 Instead of exclusivity, can a purchaser require a supplier not to deal with a particular firm?

As a general matter, an agreement of this type is less problematic than an absolute, air-tight exclusive agreement, which would prevent any other firms from obtaining inputs. As a practical matter, however, the optics of such an arrangement are poor, particularly if the purchaser demanding the condition has a significant position in the downstream market. It may be useful for the purchaser to articulate why it does not want its supplier to deal with a particular rival. Perhaps the rival is an especially close competitor, or is suspected of attempting to persuade the supplier to divulge trade secrets or other competitively significant information about the purchaser. So long as the particular rival is likely to be able to obtain access to acceptable alternative inputs elsewhere, there is not likely to be a serious legal problem. Even if the rival has trouble obtaining inputs, that does not necessarily mean that competition has been harmed, if other firms will remain vigorous rivals in the relevant downstream market. Nevertheless, agreements focused on specific rivals are always going to raise some additional risk.

Q 5.16 Is a purchaser's exclusive agreement with a supplier legal where the agreement results in the inability of one of the purchaser's large competitors to meet its supply needs?

If the competitive effect of the agreement is for either the supplier or purchaser or both to create or maintain a monopoly, there may be an antitrust issue with the exclusive arrangement. If the competitor now has to pay higher prices for its supply or has to settle for suppliers of lower quality or no supply at all, the agreement may be anticompetitive if there are no sufficiently offsetting pro-competitive benefits. If the purchaser in the exclusive arrangement has a high market share or is otherwise unique in some way, its contract with a key supplier may raise an antitrust issue.

As suggested earlier in the discussion, however, there are many economic reasons why this agreement may not be deemed

anticompetitive. The following are just the immediate questions that come to mind, which demonstrates why antitrust suits challenging exclusive agreements are rare and rarely successful:

- Did the competitor firm simply not bid aggressively enough to win the contract?
- Can the supplier terminate the agreement on relatively short notice?
- Did the agreement really increase the market power of either company to the agreement?
- Is the input a significant portion of downstream costs?
- Can the competitor make the input itself, find an alternative supplier, or sponsor new entry?
- At the end of the day, can the competitor show lost sales as a result of the agreement, as opposed to any number of other commercial factors that go into a purchasing decision? How will the competitor prove this?

Q 5.17 **Is an agreement in which a retailer pays an electronics manufacturer additional money for earlier and preferential access to new large-screen HDTVs during the holiday season legal?**

Yes, because other high-end HDTVs are likely to be available to other retailers. Moreover, it is unlikely that the retailer will be able to obtain any market power in electronics retailing (the likely relevant downstream market) merely because it has better access to a single brand of high-end televisions.

Q 5.18 **What should a market leader concerned that a new competitor will free ride on its investments consider before imposing an exclusivity requirement on its upstream suppliers?**

Consider, for example, this scenario: Company *X*, which has pioneered various high-technology products and supported a number of upstream suppliers that develop and sell design software for its products, appears to have a new competitor and wants to impose a

requirement that the upstream suppliers deal with it, Company X, exclusively. Total exclusivity could raise issues, but it is far from obvious why that would be a total nonstarter or why the company cannot find alternative contractual methods of achieving legitimate business goals.

The company should first confirm that it is, in fact, a market leader or pioneer and that it is as significant in its line of business as the company believes itself to be. (Businesspeople often think they have a greater position in the market than they actually have.)

Second, the company should confirm that the upstream design software vendors are competitively significant and that its new competitor could not perform this work itself if no other upstream vendors were able to do it for them.

Third, the company should understand that, although it may have been responsible for the creation and survival of the upstream companies, those companies are still generally entitled to deal with whomever they choose as independent entities, including the new competitor.

Fourth, where there are specific concerns about the suppliers working with the new entrant, such as the disclosure of legally protected information (trade secrets) or competitively significant information (product road map and release dates), the company might consider focusing on the particular firms having that information for exclusivity, while permitting others to work with the new entrant (if they so desire). If the company goes forward with exclusivity in any event, its businesspeople should memorialize their concerns and the absence of any alternatives for achieving their objectives.

Q 5.19 How can a retailer faced with increasing encroachments on its business from online vendors minimize antitrust risk when considering contractual restrictions on its suppliers?

A retailer in this position probably has more flexibility than it thinks, but it will need to stay on top of its businesspeople to minimize continuing antitrust risks. In this kind of situation (which is similar to the Toys “R” Us Case Study above), a company might be considering, for example, requiring its suppliers to deal exclusively with it, to require them to deal only with brick-and-mortar retailers, or perhaps

to permit them to sell on their own websites but not through other online retailers. A company in this position should do the following:

1. Identify the universe of products for which exclusivity or preferential access is being sought—only then can the significance of the exclusivity be understood.
2. Determine what is being sought—better prices, better allocations, or exclusive supply arrangements. This could make a significant difference in the competitive analysis. The company also needs to understand the significance of the targeted suppliers within each of their product categories.
3. Decide if it is comfortable with contracts of limited duration and/or easy terminability or walk-away provisions for its suppliers. A company that is comfortable with this approach may have more flexibility in achieving its objectives.
4. Define the business objectives more specifically than “Ensure that new online distribution channels do not grow”—for example: Is the business concerned that consumers will visit its stores and then purchase the goods online? Could the business therefore seek greater allowances in exchange for its promotional services instead of obtaining exclusivity?
5. If the business has targeted online distribution alone, the company should ensure that it does not discuss this issue with other brick-and-mortar retailers, either through formal bodies like trade associations or through informal chit chat.
6. If the business still wants to go forward, explore the likely impact of the project on prices at the retail level. Is this designed to achieve price stability? Preserve existing market share? Will online retailers be able to remain competitive?
7. Ensure that discussions with upstream suppliers are managed carefully and appropriately. Shuttle diplomacy among otherwise competing suppliers is exactly what got Toys “R” Us and its suppliers into antitrust trouble.
8. The company should be careful about agreeing with its supplier about the terms on which the supplier conducts its own online business. Although a company is free not to do business with companies that distribute their products through their own websites, it does not have unlimited discretion to discuss or dictate the terms on which the supplier can compete with it. (This issue is discussed in more detail in the next section.)

Exclusive Distribution Agreements

Q 5.20 What is an exclusive distribution agreement?

An exclusive distributorship is an agreement by the manufacturer that it will not supply a particular product or brand to any other distributor or retailer in a defined territory or sometimes in a particular class of trade.

Q 5.21 Do exclusive distribution agreements raise any significant antitrust issues?

Generally, no. Because individual manufacturers are unlikely to have market power and because individual distributors or retailers are even more unlikely to have meaningful market power, exclusive distributorships generally should not raise significant antitrust issues. In fact, exclusivity can significantly reduce the potential headaches (including antitrust-related migraines) that can often arise from administering a distribution system involving multiple distributors or retailers. However, because changes in distribution systems can have significant consequences on individual distributors or retailers, transitions to exclusivity can often lead to antitrust questions both from the manufacturer's business executives and from the distributors or retailers affected by the transition.

Q 5.22 What are the pro-competitive justifications for an exclusive distribution system?

There are a number of benefits to an exclusive distribution system. By having an exclusive system, manufacturers or sellers can:

- (1) lower administrative costs by dealing with fewer distributors;
- (2) gain greater sales commitment from its exclusive distributors and avoid free riding by competing distributors; and
- (3) better supervise the distribution system.

Often such systems are created to limit intra-brand competition, thereby increasing an exclusive distributor's incentive to promote that manufacturer's product.

Courts will also consider the pro-competitive effects of the exclusivity when considering the arrangement, including the need to eliminate free riding (which can occur with multiple retailers), incentivize appropriate investments in promotion and advertising, reduce administrative and transaction costs, and, in some cases, reflect the exclusive image that the business wants to project.

Q 5.23 Doesn't the transition to an exclusive distributorship from a system involving multiple retailers eliminate competition by definition?

In a narrow sense, yes; but in an antitrust sense, not necessarily. A company wishing to move from an open-distribution network to an exclusive distribution network generally can do so without significant antitrust risks. While the rationale for an exclusive distribution system remains the same, if a company already uses an open-distribution system, its current distributors, some of whom may lose business, may question the reasoning for the change. Also, a manufacturer claiming that an exclusive distribution system is needed to ensure sales commitment or that the nature of the product requires greater distribution control may have that rationale undermined by its having previously operated an open-distribution system, unless it can show why the previous system was unsatisfactory.

Even though such an action may involve greater scrutiny from the manufacturer's current distributors, courts have consistently held that the unilateral decision of a firm to rearrange its distribution network, by itself, does not run afoul of the antitrust laws, unless it can be shown that doing so will reduce competition in a relevant market. Absent unusual facts, the relevant market will not only include the company's product, but all substitutes. So, while there will be less competition in the sale of the specific company's product, the real issue is the effect on competition in the entire relevant market.

As discussed earlier in this chapter, if the transition to exclusivity relates to a broader agreement on resale pricing, even with a single reseller, it is possible that a company choosing exclusivity could continue to face antitrust risk under applicable state laws.

Q 5.24 Can a manufacturer terminate an existing exclusive distributor and appoint a new exclusive distributor?

Even more obvious than switching from an open-distribution system to an exclusive distribution, terminating one exclusive dealer for another, by itself, will not violate the antitrust laws.³ In this situation, a firm has already determined that an exclusive-distribution system is its best model, and changing to a different exclusive distributor should not cause any antitrust concern.

Q 5.25 How much control can a manufacturer assert over its exclusive distributors?

Companies may impose significant restrictions on exclusive distributors without raising competitive concerns. Such restrictions include packaging, advertising, or marketing requirements or best-practices requirements that ensure efficient product delivery or specified levels of customer service.

Q 5.26 What practical challenges and risks does a business face when considering an exclusive distributorship?

If the business is creating a new distribution system from scratch, it should not face any theoretical or practical antitrust risks in establishing exclusive distributorships.

If the business is transitioning to an exclusive distributorship system from a more open network of distributors, it is not likely to have serious risks, but it may have to face practical challenges from distributors that will no longer carry the company's product. The business should determine whether it has a significant position in the upstream market, and the practical impact of the transition to the system on inter-brand competition. Will terminated retailers have access to other products? If not, will consumers continue to have the access they require? Why does the business believe that exclusivity is important now?

Because there is always the risk of conspiracy allegations in this context, it is also useful for the company to understand its relationship

with the distributor that will be given exclusivity. Has that firm complained about price-cutting by other retailers? Was the decision to go to exclusive distributors made before deciding which retailers would distribute the product? Establishing and memorializing the company's independent business interest in an exclusive distribution system will be useful in rebutting any subsequent allegations of conspiracy down the road.



CASE STUDY: Territorial Restraints on Distribution

Assume a manufacturer wishes to reorganize its world-wide dealer network so that each dealer will have exclusive geographic territories. Currently, some dealers have nonexclusive territories, and this is creating disputes among dealers. Can the company terminate some dealers' nonexclusive territories and create a network of dealers with exclusive territories?

In the United States, courts generally give manufacturers wide latitude in their decisions on how to organize and structure their distribution networks. As long as a manufacturer is acting unilaterally, it will not face much antitrust risk in making changes to its dealer structure. However, the manufacturer should avoid any agreement with a dealer or group of dealers about changing its system, because these types of agreements have been held to be unlawful agreements in violation of section 1 of the Sherman Act. Distributors that experience changes may not like the change. A manufacturer should be clear in its statements about its reasons for the change. It should not imply that it has agreed to this change because any dealer or group of dealers desires it. This decision must be made by the manufacturer alone for its own business reasons. There are more complicated issues in other jurisdictions that frequently do not permit manufacturers as much freedom as is typical in the United States.

Q 5.27 Can a manufacturer restrict its distributors to selling only in certain geographic territories?

Courts have long held that territorial restraints benefit inter-brand competition by allowing the manufacturer to strengthen its brand through better control of its distribution network, thus making the manufacturer better able to compete against other brands. Like other non-price vertical restraints, such terms will generally not be subject to successful challenge unless the plaintiff first establishes that the manufacturer has market power.

An agreement limiting a distributor to certain defined geographic territories will be evaluated under the rule of reason. A court examining a geographic territory restriction would first assess whether the manufacturer has market power; if the manufacturer has market power, the court then would examine the nature, purpose, and effect of the geographic-area limitation on competition. Generally these types of provisions do not pose much antitrust risk, and in the vast majority of litigated cases, they have been upheld.

Q 5.28 Can a manufacturer that is having difficulty serving customers in certain geographies appoint a distributor in those areas and agree that the distributor will not compete with the manufacturer in its home territory?

In appointing a new distributor, manufacturers can specify that the distributor's territory is limited to a certain defined geography. It is also generally permissible to specify in the distribution agreement that the distributor will not sell in the manufacturer's home territory, or to particular classes of customers that the manufacturer reserves for itself (for example, national accounts). Unless the manufacturer has market power, these types of agreements are not likely to face successful challenge. Even if the manufacturer does have market power, a court would then inquire whether the restriction adversely affects intra-brand competition, to the consumer's detriment.

As discussed earlier (see QQ 5.7 and 5.7.1), where the manufacturer is also a distributor and then appoints additional independent distributors with whom the manufacturer competes (so-called dual-distribution agreements), arrangements between the manufacturer and competing distributors can be challenged under section 1 of the Sherman Act as horizontal, rather than vertical, agreements. In most litigated cases, however, the courts have concluded that these agreements should be evaluated as other non-price vertical restraints are evaluated. In a small number of cases, territorial restraints imposed by manufacturers with substantial market power on their distributors have been found to illegally impede intra-brand competition. In a market with little inter-brand competition, such limitations on intra-brand competition could be found to eliminate the little competition that exists.



CASE STUDY: Requiring Customer Exclusivity

A manufacturer would like to enter into an agreement with a new distributor, which would sell only to a new category of customers not reached by the existing sales network. Can the manufacturer limit this new distributor only to this category of customers? Can it agree with the new distributor that it will not target the manufacturer's existing customers?

Customer exclusivity is usually a permissible vertical non-price restraint. In this case, the pro-competitive rationale for the restriction would be to more effectively reach customers that are not now being served by the existing network. In this context, the goal could be achieved by specifying that the distributor will serve only a defined class of customers, or that sales to certain customers or classes of customers are reserved to the manufacturer. Courts evaluating these types of restrictions have generally concluded that they serve a valid, pro-competitive purpose of the manufacturer.

Q 5.29 Can a manufacturer prohibit its distributors from selling to consumers on the Internet?

Yes. While the antitrust laws apply to restraints governing e-commerce to the same extent that they apply to other types of restraints on distributors, this type of provision is generally acceptable. A clause prohibiting a distributor from selling on the Internet would be evaluated as any other territorial or customer restriction would be evaluated.

TIP: As with any change in the terms of a distribution agreement, if a manufacturer seeks to impose a new restriction against Internet sales on its existing distributors, it is important that the decision be reached by the manufacturer alone, and not in response to or at the direction of its existing distributors who may be trying to ward off competition from other, more aggressive distributors.

Changing the terms of a distribution agreement in response to complaints by a disgruntled distributor or group of distributors carries the risk that a court could find that the new term is the result of an agreement intended to reduce competition and thus violates section 1 of the Sherman Act—that is, that the manufacturer facilitated and thus participated in collusive behavior among its distributors by imposing the restriction.

Q 5.30 Can a manufacturer penalize its dealers for selling outside of their assigned geographic territory?

Yes. Manufacturers have used a variety of contractual provisions to enforce territorial restrictions. For example, a distributor that sells outside of its assigned geographic territory and into the territory of another distributor could be required to make a payment to the distributor in whose territory the sale was made. The rationale for such “profit pass over” or “warranty service” fees is to compensate the

distributor in whose territory the sale was made for its promotional expenses and costs incurred in providing service. Most courts evaluating such arrangements have concluded, under a rule-of-reason analysis, that they are not anticompetitive. However, the fee paid should be proportionate to the loss incurred by the distributor in whose territory the sale was made.



CASE STUDY: Requiring Distributors to Sell Only the Manufacturer's Disposables with Its Hardware

A firm manufactures hardware and disposable products that are used with the hardware. Hardware users can use disposables manufactured by others with the OEM equipment, but the manufacturer warns that equipment will not function as well as it does with its disposables. The manufacturer would like to agree with its distributors that they will sell only the manufacturer's disposables for use with its hardware. Can this be done?

For a manufacturer that does not possess market power, this type of agreement would pose little antitrust risk. If the manufacturer possesses market power in a properly defined relevant product for the hardware, it would be important to evaluate carefully whether this type of arrangement could foreclose any competing manufacturer of disposables from making substantial sales of disposables that are currently being used with an installed base of the manufacturer's hardware. In addition, there is some risk that requiring distributors to sell only the manufacturer's disposables with its hardware could be challenged as an unlawful tying arrangement (discussed in chapter 8), whereby the manufacturer requires its customers to purchase the disposables as a condition of purchasing the hardware. Before implementing such a requirement, therefore, a careful analysis of the competitive landscape for hardware and disposables should be done to evaluate whether competition for hardware or disposables could be affected.

Exclusive Dealing

Q 5.31 What is exclusive dealing?

Exclusive dealing is the term used to describe vertical agreements that require a customer or distributor to purchase all or most products or services from one supplier for a specified period of time. Most franchise operations involve some form of exclusive dealing. Exclusive dealing can take a number of forms, including requirements contracts, agreements forbidding purchases from the supplier's competitors, or agreements to purchase all of the supplier's output.

Q 5.31.1 How can exclusive dealing encourage retailers to invest adequately in the services essential to sell the supplier's products effectively?

The potential pro-competitive impact of particular restrictions obviously depends on the restriction itself. But as a general matter, many restrictions are designed to prevent free riding. Free riding occurs when a firm benefits from a particular service or promotion without having to internalize the cost of providing it. In the distribution context, this can occur when a retailer providing little or no service or promotion offers lower prices on a particular brand promoted or serviced more effectively by other, higher-priced retailers. Certain restrictions may be designed to ensure that all retailers maintain the right incentive to continue promoting and servicing their supplier's products.

Q 5.31.2 How can exclusive dealing enhance the competitiveness of the supplier's products?

Manufacturers may also attempt to impose exclusivity to prevent retailers from having divided loyalties when promoting and selling products. Some manufacturers may feel that retailers should devote all of their efforts to their own brands and may also dislike the possibility that a multi-brand customer could disclose competitively sensitive information to other suppliers. A stronger justification for exclusivity may be that suppliers are more inclined to engage in price-related and non-price promotion with their retailers if they are confident that retailers will not then sell other brands to customers attracted by the promotional activities.

Q 5.31.3 How can exclusive dealing enhance pro-competitive collaborations involving confidential or proprietary information?

In relationships involving complementary goods, exclusivity may be desirable or necessary to protect confidential information and intellectual property from being disclosed to or misappropriated by competitors. Just as aligning the incentives of suppliers and retailers through exclusivity may enhance inter-brand competitiveness, so too might exclusive relationships between developers and sellers of complementary products. That is particularly true in cases of joint development of new products where either or both of the parties may be reluctant to cooperate as extensively if they believed their partner would be able to support their competitors with jointly developed technology.

Q 5.32 What do courts look at in an antitrust analysis of an exclusive dealing arrangement?

In analyzing exclusive dealing arrangements, and their potential anticompetitive effects, courts will look to the percentage of the downstream market foreclosed to competing sellers by the arrangements. In cases where a supplier relies completely on exclusive dealing, foreclosure is likely to reflect market share. While courts continue to focus on foreclosure, they have also looked at whether competitors are still able to reach ultimate consumers, even though some distributors are unavailable to those competitors due to the exclusive dealing restrictions; whether there are alternative distribution possibilities open to a seller's competitors; and the length of the exclusive arrangement (including terminability provisions and penalties).

As a practical matter, exclusive dealing is likely to attract significant antitrust attention only when the scale of exclusivity is so significant that other competitors cannot obtain effective access to the marketplace. "Why would retailers agree to do something that appears to harm their interests?"—one of the persistent questions in non-price vertical restraint analysis—is especially applicable in this environment. One answer might be that retailers or distributors had no choice in the matter—that switching completely to a new entrant for all requirements would not be practical (because a significant portion of purchasers will continue to demand the dominant firms' product) or possible (because a new entrant may be capacity-constrained).

Other answers, however, such as the availability of a better price from the manufacturer, make the analysis considerably more complicated.

Q 5.32.1 What are the roles of duration and terminability in the antitrust analysis of exclusive dealing agreements?

Shorter exclusive dealing contracts are—all other things being equal—less likely to raise antitrust issues than longer-term contracts. Most courts have held that contracts lasting a year or less are not likely to be problematic, regardless of the manufacturer's market share or quantitative levels of downstream foreclosure. Obviously, when contracts are terminable at will, or on short notice, and without penalty, it is difficult to view them as exclusive in any meaningful sense of that word.

Q 5.32.2 What role do justifications play in analyzing exclusive dealing agreements?

Assuming exclusivity would cover a significant portion of downstream purchasers (in excess of 35% of downstream volume or revenues), and assuming further that contracts last for over a year and are not easily terminated, then it is important for a business to understand why it requires its dealers to be exclusive, particularly when it has not been exclusive before. (Many of the potential justifications for exclusivity are discussed above in this chapter.) As a practical matter, it is often difficult to know how credible a justification will be after discovery and depositions and in summary judgment motions or trial. Courts have not articulated any meaningful or practical standard for determining how much or what kinds of pro-competitive benefits are sufficient to outweigh a potential anticompetitive effect.

What is clear, however, is that justifications need to be related to enhancing consumer welfare. Pointing to the desire to increase profitability is an explanation, not a justification. Of course, the two are not mutually exclusive. In fact, for a justification to be effective in any sense, it needs to involve both. Equally important, the justification needs to be genuine, not pretextual. This does not mean that a business's corporate motive needs to be exclusively pro-competitive. We all know that a single corporate motive rarely exists (if, in fact, there

is such a thing as a “corporate” motive). It is generally sufficient to identify plausible justifications for exclusivity, understand how they relate to consumer welfare, and ensure that the contemporaneous documents reflect this in some manner. More is rarely possible without significantly more detailed review of documents and interviews of personnel.

The truth is that market evolution and context often mean significantly more to a court or enforcement agency than justifications that often reflect the creativity of lawyers and economists. Transitions to exclusivity as market share grows raise the inference that firms with increasing presence in the market are able to extract contractual exclusivity they do not require. After all, if they grew without exclusivity, why do they need it as they become more mature? Transitions also may imply a fear about new competitive threats and represent an attempt to prevent new competitive threats from emerging. Thus, it is important to keep in mind that even the most justifiable practices look different when it appears they exist only to exclude or impair new competitors, or when they arise simply as a function of increasing power.

Q 5.33 Do minimum purchase requirements raise antitrust risks?

Generally, as long as the exclusive arrangements do not preclude competing manufacturers from selling to the buyer, minimum purchase requirements do not raise competition concerns. However, if the minimum purchase requirement in effect creates an exclusive dealing arrangement and forecloses the majority of a buyer’s business from rival sellers, then it may be analyzed as an exclusive dealing arrangement.

Q 5.34 What kind of antitrust risks arise from making promotional allowance programs contingent upon exclusivity within certain stores, or on certain portions of the shelf, or in retail promotional materials (like Sunday newspaper circulars)?

Because these programs tend to be significantly less drastic than exclusive dealing and often reflect pro-competitive incentives for retailers, they are generally less likely to raise antitrust risks than

**CASE STUDY**

“XYZ” is the leading manufacturer of self-installed fire alarm systems with approximately 70% of the market. Other firms have inferior systems and have suffered declines in market share. However, XYZ is beginning to face more significant competition from Internet sales by other manufacturers. It also faces increasing competition from firms offering both the alarm system and installation (along with maintenance). Finally, and most importantly, XYZ faces competition from a significant new competitor that recently obtained low-cost distribution through one large home store/mass merchandising company for whom XYZ has been the only vendor for a significant period of time. Can XYZ seek exclusive dealing agreements with other retailers?

Perhaps. But XYZ must analyze the facts in significantly more detail before proceeding, and it must inform its executives that, if the quest is successful across many distributors, it may face a significant antitrust challenge from the new competitors. Here is how XYZ might address the facts before it:

1. Look at the business’s market share. XYZ undoubtedly feels competitive pressure on all sides and will call the 70% market share irrelevant, misleading, or incorrect. All of that may be true, and in a courtroom, all of the competitive pressures faced by XYZ should be explained. However, for antitrust counseling purposes, it is prudent for XYZ to assume the narrowest plausible market and proceed from there. If its market share were below 30%, XYZ could be fairly comfortable no antitrust issues would be raised. But 70% means XYZ should dig deeper and look harder.
2. Examine the program that the business would like to implement. Does XYZ intend to request exclusives from all retailers, or just certain retailers? Is it likely to succeed? What additional consideration does it intend to offer to retailers to induce exclusivity? What will be the duration of the contracts,

and what are the terminability provisions? If the program is limited only to a portion of the business's distributors and if the duration is limited, then the program is significantly less likely to result in antitrust risks.

3. Understand the reasons for exclusivity. Why is exclusivity being pursued now when it has not been required in the past? Is it because the business is concerned that the new competitor is likely to free ride on its investments in promoting the product to consumers, or training sales force personnel? Has that already happened at the major retailer where the new entrant has secured distribution? Why was XYZ not concerned in the past about other suppliers doing the same?
4. Understand how all of the pieces fit together. If, as XYZ's businesspeople will say, a well-trained sales force and displays are essential to selling the product, why are sales through the Internet growing? Do those sales involve products also sold through retail? Conversely, if Internet distribution is so effective, then will exclusivity have any anticompetitive impact on the new entrant? And even if exclusivity could have such an impact, what, if anything, prevents the new entrant from competing for exclusivity?
5. Identify alternatives. If the business has not committed to going forward with an exclusive dealing agreement, explain the availability of alternatives that could allow achievement of these objectives, such as targeted merchandising programs, straightforward refusals to deal with merchandisers selling other systems, and requirements for floor space and sales force commitment.

outright exclusivity. However, as is the case with exclusive dealing programs by certain retailers, it is possible that consumer demand (coupled with intense retail competition) may force distributors and retailers to accept these programs, even if they would prefer not to do so. As a practical matter, however, such promotional programs are

unlikely to raise significant antitrust issues even when imposed by a dominant firm, unless neither retailers nor consumers benefit from them. Promotional allowances can also raise issues under the Robinson-Patman Act, as discussed in chapter 8, so it is advisable to consider that act when designing promotional programs.

Q 5.35 What is a most-favored-nation clause?

A most-favored-nation clause—also called a “most-favored-customer clause,” “prudent buyer clause,” or “nondiscrimination clause”—typically is a clause through which the seller promises the buyer that it will not deal with another buyer on any better terms, usually promising that, if it offers a lower price to another buyer, it will provide the first buyer with the same or better pricing.

Q 5.35.1 Do most-favored-nation clauses pose antitrust risks?

MFN clauses have been subject to challenge by federal and state enforcers, which have obtained consent decrees prohibiting certain MFN clauses in certain limited fact situations, but most court challenges have not found such clauses illegal. In addition to challenging such clauses directly as an unreasonable restraint of trade under section 1 of the Sherman Act or as part of a section 2 monopolization claim, MFN clauses may be used as evidence of monopoly power in a broader challenge to a buyer’s conduct.

MFN clauses are common and are evaluated under a rule-of-reason analysis in which any potential anticompetitive harms are balanced against pro-competitive benefits. The primary pro-competitive benefit that results from MFN clauses is cost savings for buyers that can be passed on to downstream consumers in the form of lower prices. If such actual savings can be shown, the MFN clause is not likely to be anticompetitive in either its purpose or effect. On the other hand, there may be concerns that an MFN clause could discourage price competition and price cutting because the supplier will not want to make more favorable pricing to one customer widely available. In addition, if the buyer has market power and there are no offsetting benefits, the MFN clause could be seen as a means to maintain a monopoly.

U.S. antitrust agencies historically have had a particular concern about the use of MFN clauses in the healthcare industry, especially when used by purchasers with buying power where the clause prevents competitors of the purchaser from obtaining comparable or superior discounts from suppliers or may even require suppliers to provide less favorable terms to competing purchasers. The U.S. antitrust agencies have also raised concerns about the coordinated adoption by competing suppliers of MFNs in their customer contracts in order to facilitate price fixing. In the absence of such buyer market power or supplier coordination, MFN clauses generally benefit competition and consumers and are encouraged by the antitrust laws.



CASE STUDY: *United States v. Delta Dental of Rhode Island*⁴

The DOJ alleged that dental insurer Delta Dental's MFN clause with dentists had the effect of restricting price competition among Rhode Island dentists. The Delta Dental MFN clause required dentists charging lower fees to other insurers to offer that same lower fee to Delta Dental. According to the DOJ, the MFN clause created a disincentive for dentists to discount their services to other payors, resulting in higher prices for consumers and lower output. The DOJ alleged Delta Dental had a 35% to 45% share of the dental insurance market and that 90% of practicing Rhode Island dentists accepted Delta Dental. Rhode Island dentists could not afford to give Delta Dental the same discounts they would have given the other payors because Delta Dental was such a significant source of income for the dentists. The DOJ also alleged that the MFN clause had the effect of deterring low-cost dental plans' entry or expansion in Rhode Island. The district court denied Delta Dental's motion to dismiss the complaint, finding that the DOJ had presented sufficient evidence that MFN clauses had anticompetitive effects. The case ultimately settled with a consent decree prohibiting Delta Dental from using MFN clauses.

Q 5.36 What is reciprocal dealing?

Reciprocal dealing, or reciprocity, takes place when one party to a transaction conditions its purchase or sale of products or services on the agreement of the other party to enter into a reciprocal transaction—for example, Company A will agree to buy goods from Company B only if Company B makes a corresponding purchase from Company A.

Q 5.36.1 Does reciprocity pose antitrust risks?

The Supreme Court has never directly addressed reciprocal dealing, but some lower court decisions have occasionally found it per se unlawful under an analysis similar to tying. Findings of liability have been rare and generally involve situations where there is significant market power or clear coercion. In most cases, such claims are dismissed due to lack of any market power or adverse effect on competition.

Resale Price Maintenance/Vertical Price Fixing**Q 5.37 What is resale price maintenance?**

Resale price maintenance is an agreement or understanding between a supplier and a reseller on what price the reseller will charge for the product to its customers. Minimum RPM creates a floor on resale prices and is generally designed to promote dealer service (and protect retail margins) on the product. Maximum RPM imposes a ceiling on dealer resale prices and is often designed to prevent retailers from enhancing their own margins at the supplier's expense through higher retail prices.

Q 5.37.1 Isn't resale price maintenance just another form of illegal price fixing?

RPM is literally a form of price fixing, and so for decades in the United States both minimum and maximum resale price maintenance were treated as per se illegal, but not anymore. In 1997, the Supreme Court held that maximum RPM should be evaluated under

the rule of reason, since it was not inevitably (or perhaps not even frequently) likely to harm consumers. Minimum RPM remained per se illegal until 2007, when the Supreme Court reversed ninety years of jurisprudence and ruled that the rule of reason should also apply to minimum RPM.



CASE STUDY: *State Oil Co. v. Kahn*⁵

A gas station owner sued its supplier for unlawful maximum price fixing, alleging that its supply contract, which required it to rebate to the supplier any customer payments exceeding the manufacturer's suggested resale price, constituted unlawful price fixing. The Supreme Court rejected this claim, finding "insufficient economic justification" for continued per se treatment of maximum RPM. In reaching this conclusion, the Court emphasized that maximum price fixing—which essentially imposes a ceiling on what the retailer can charge—should keep prices low and, thus, benefit consumers. It also questioned the potential for any adverse effect on competition and noted that continuing to apply per se treatment to maximum RPM could have the perverse effect of encouraging suppliers to integrate forward in the distribution chain, eliminating independent distributors in the process. The Court did note, however, that a maximum resale price strategy might affect competition in three ways: (1) it could depress reseller margins to such an extent that the resellers could not economically offer services that customers desired; (2) distribution could become consolidated among fewer, more efficient distributors; or (3) it could actually act as a minimum resale price scheme. The court concluded that the first was unlikely, the second was not necessarily an antitrust problem, and the third was amenable to a rule-of-reason analysis.



CASE STUDY: *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.*⁶

In *Leegin*, the Supreme Court overturned its prior cases that held minimum resale price maintenance per se unlawful.

Leegin designed and manufactured women's accessories, which were mainly sold in small, independent boutiques. Leegin implemented a "Retail Pricing and Promotion Policy," under which it refused to sell to any retailer that discounted its products below suggested prices. According to Leegin, the policy ensured small retailers sufficient margins to provide high-quality customer service and prevented any discounting from tarnishing its brand image.

In a lawsuit brought by a retailer that Leegin had terminated for failing to adhere to its pricing policy, the Supreme Court held that vertical minimum resale price agreements should be evaluated under the rule of reason, like other vertical agreements. While the Court noted that such agreements can have anticompetitive consequences, depending on the circumstances, it nevertheless concluded that per se treatment of minimum resale price agreements is not warranted because "it cannot be stated with any degree of confidence that resale price maintenance 'always or almost always tend[s] to restrict competition and decrease output.'"

Because RPM is a vertical agreement, not an agreement between competitors, it is less likely than a similar horizontal agreement to harm consumer welfare. In fact, RPM is justified in many cases by the same pro-competitive reasons that justify vertical non-price restraints. Minimum RPM can allow a manufacturer to encourage retailers to promote its products by protecting the retailers' investments in service against free-riding discounters. Nonetheless, the fact that RPM is an agreement on price—and at least with respect to minimum RPM appears to some to harm consumers by denying them lower prices that retailers may want to offer—overcame this economic logic for a very long time. Still today there remains significant resistance to this logic at the state level, where under some states' statutes minimum

RPM remains per se illegal, and in the U.S. Congress, where legislation that would once again subject minimum RPM to the per se rule has been repeatedly introduced.

Q 5.38 What are the risks that a supplier should consider in its decision to impose an RPM program?

Following *Leegin*, suppliers obviously have more flexibility, but careful analysis of the facts and circumstances of the particular markets in question is important. While RPM agreements are for the moment afforded rule-of-reason treatment under the federal antitrust laws, it is nevertheless possible that such agreements (especially minimum RPM) could be found to harm competition if the manufacturer imposing the agreement has market power. When a supplier seeking to impose a minimum RPM has market power, the chances are higher that the requirement will be subject to scrutiny. Also, as the Court noted in *Leegin*, if all or many of the manufacturers in a particular industry impose similar minimum RPM on their distributors, these contractual clauses could facilitate collusion among all of the manufacturers in an industry.

Furthermore, beyond the risk under the rule of reason, there is the risk that an RPM program could still be found per se illegal under some state laws. Before *Leegin*, important jurisdictions like New Jersey and California prohibited RPM under their state antitrust laws, and those state laws still exist. Post-*Leegin*, and in response to it, several other states have passed statutes explicitly prohibiting minimum RPM. These actions reflect more concern with retailer freedom and less interest in the economic justifications for RPM by firms that do not have market power. So while *Leegin* has made minimum RPM substantially less risky under federal law, it is still important to evaluate carefully whether a minimum RPM requirement has the potential to harm competition in your particular industry, as well as whether you are subject to particular state laws that may continue to make minimum RPM per se unlawful.

Finally, jurisdictions outside the United States often have a very different approach to RPM, and global pricing policies should be carefully evaluated in every jurisdiction where they will be in force (see Q 5.43).

TIP: Legislation has been introduced in the Congress to reverse the Supreme Court's recent RPM decision, so the legal standard in this area could change. Parties faced with this issue should consult an antitrust expert.

Q 5.39 What legal methods are there for influencing resale prices short of entering formal or informal agreements with resellers?

Prior to *Leegin*, suppliers could lawfully unilaterally suggest a minimum resale price, encourage their resellers to adhere to a minimum price, discuss the reason for the minimum price, and terminate those resellers that refused to sell at the suggested resale price. These are called *Colgate* programs, named after an earlier Supreme Court decision that found these practices lawful.⁷ *Colgate* and its progeny were early reactions to the overreaching nature of the per se rule against RPM. Entering into an actual agreement about minimum retail pricing, as opposed to these unilateral policies and actions, was deemed to be an agreement that was per se unlawful. Coercive tactics such as threatening termination to secure a retailer's compliance have also been held to be an agreement for purposes of section 1 of the Sherman Act.

Over time, however, the Supreme Court substantially increased the legal threshold for circumstantial evidence sufficient to give rise to an inference of agreement under the Sherman Act. Because communications between buyers and sellers are ubiquitous and essential to a stable, pro-competitive relationship, the Supreme Court has held that communications and actions that are as consistent with unilateral action as with concerted action are not sufficient to support a section 1 claim.

As a practical matter, this made life more difficult for plaintiffs on two fronts, even before *Leegin*. First, threats to terminate even

when followed by retail price increases are themselves less likely to support claims of an RPM agreement. Second, communications between the supplier and complaining retailers are less likely to support claims of a broader agreement between the manufacturer and complaining retailers. The net result, even before *Leegin*, was to give those manufacturers that believed control over retail prices was important to their competitive strategy a fair amount of flexibility. Whether these techniques would remain available if and when any legislation is adopted to reverse *Leegin* will depend on the language of the legislation.

Q 5.40 How does a national accounts program work?

Manufacturers that want to become more involved in selling to national accounts without implementing an RPM program have successfully implemented national accounts programs by negotiating price directly with their large customers that purchase products for use nationwide and then offering the sales to local distributors at the negotiated price. The local distributor is free to accept the sale at that price or not.

Q 5.40.1 What kind of legal exposure does a national accounts program create?

Courts have long held that, due to their voluntary nature, national accounts programs should be evaluated under the rule of reason. Post-*Leegin*, specifying a resale price to be offered by a distributor under a national accounts program should present very little federal antitrust risk, but state laws and the language of any post-*Leegin* federal legislation, if any, will still need to be considered.

In dual-distribution situations, where a manufacturer distributes its products and also appoints independent distributors, a manufacturer theoretically faces more antitrust risk in specifying the prices at which its dealers will resell to customers. Most courts evaluating non-price restraints in dual-distribution situations have determined that the restraints are vertical, and thus subject to rule-of-reason analysis. The law on price restraints in this area is not yet well developed following

Leegin, so these types of agreements should be carefully evaluated in light of the particular competitive circumstances.

Q 5.41 Can a manufacturer implement an RPM program where several retailers have asked it to do so to help them compete more effectively against the big-box retailers who also distribute the manufacturer's products?

Probably. But the manner in which this program is implemented could have a significant impact on the potential antitrust risks for the manufacturer.

The first step is to assess the risk under federal antitrust law: define a provisional relevant market, determine the manufacturer's share in it, then determine why it is believed that imposing resale price restrictions is likely to increase the company's sales of the relevant product. Does the product require significant service from retailers? A business that has either a low market share or a good reason for transitioning to an RPM program can be more confident that it is not likely to have significant antitrust risks. Even if the business has a low market share, it would be prudent to memorialize the objectives the business is seeking in implementing the program.

There are two other considerations that need to be incorporated into the assessment. The first is a legal one. Are there state antitrust laws that could be used to challenge the program? The second consideration is a factual one. Is the pressure from retailers the result of separate, individual complaints, or are the retailers communicating with each other and putting concerted pressure on the business? This is a tougher question to answer. Obviously, retailers may be talking to each other without the knowledge of the manufacturer, which needs to be careful about being caught in a broader agreement among dealers to impose disadvantageous terms on larger or more efficient retailers. This can be depicted in courtrooms as a form of dealer cartel and is likely to get a more sympathetic look from juries when the targets are mom-and-pop stores, not big-box retailers. Unlike a simple RPM agreement, a broader agreement between a supplier and a dealer cartel may not receive rule-of-reason

treatment even under federal antitrust law. Under these circumstances, it should be determined whether the retailer complaints have occurred close in time, or seem similar in tone or focus, or are coming from retailers that are known to discuss and cooperate legally on other matters, and whether the dealers themselves have indicated that they are acting in unison.

Q 5.41.1 Can a business use promotional funds (like advertising payments) to influence retailer prices?

Generally, yes. A Minimum Advertised Price policy can condition receipt of cooperative advertising or other promotional payments on a reseller's adherence to suggested advertised prices. A MAP program can be implemented unilaterally or by agreement. Courts have evaluated these types of programs under the rule of reason unless the parties also agreed to actual resale prices. As a practical matter, a business needs to be careful when implementing such policies. Constant monitoring and enforcement of resale prices, coupled with frequent communications with retailers (and complaints about other matters), can often be used as circumstantial evidence of a broader resale price maintenance agreement.

Q 5.41.2 Is a unilateral refusal to deal likely to give rise to antitrust risks?

A unilateral refusal to deal, even by a monopolist, is not likely to give rise to any significant antitrust risks where it does not exclude, or if it is exclusionary, where the decision is supported by a plausible business justification. For example, where a retailer concentrated in rural areas consistently marks up a manufacturer's products significantly beyond the retail prices that the manufacturer believes are appropriate for the product, the manufacturer would likely have a plausible business justification to terminate the distributor or take other measures short of termination to achieve its objective and could probably do either one with no fear of likely antitrust liability under federal law. Assuming the manufacturer does not want to terminate the retailer, and assuming further it has no risks under state antitrust law, it should consider setting a resale price ceiling, which would be evaluated under the rule of reason.

Q 5.42 As a practical matter, how should businesses deal with RPM issues?

A business considering an explicit agreement to impose RPM should first assess its appetite for potential exposure under state antitrust laws. Important commercial states like California and New Jersey continue to have state antitrust laws that make RPM per se illegal. State attorneys general have also been active post-*Leegin* in challenging RPM agreements under state antitrust statutes.

Assuming such laws do not apply, the business should then ensure that the agreement does in fact fall into the category of RPM. Agreements with customers that also happen to be competitors in the same space can raise significant legal and practical issues.

Assuming the agreement does fall within the classic RPM paradigm, the business should ensure that it has appropriately memorialized its independent business interest and judgment in proceeding with resale price maintenance. In other words, the contemporaneous record should reflect the fact that going forward with the agreement is the decision of the business, not the result of pressure from a group of retailers that have gotten together and forced the business to do something that it believes is inconsistent with its independent interests.

Alternatively, businesses that are either unable or unwilling to go forward with actual RPM agreements should consider how to implement *Colgate* programs. The business should announce the terms on which it intends to do business and the suggested resale prices to dealers. It should feel free to use promotional programs to meet its objectives, and it should ensure that discussions with noncompliant retailers involve only persuasion, not coercion—though that is understandably a difficult line both to draw and referee.

Outside the United States**Q 5.43 How are vertical distribution issues generally treated outside the United States?**

Vertical distribution issues are treated very differently by most jurisdictions outside the United States. The analysis is more

mechanical, less focused on economics, and, in the EU, affected by the overarching goal of creating a single market. Most jurisdictions in the world tend to copy the EU's more civil law-oriented, rules-based approach to antitrust.

Q 5.44 How are vertical distribution issues treated in the European Union?

In the EU, vertical agreements, including supply agreements, are examined under article 101 of the TFEU (Treaty on the Functioning of the EU).⁸ If they have the object or effect of appreciably preventing, restricting, or distorting competition within the EU and may affect trade between EU member states, such agreements are prohibited, unless they fall within a safe harbor “block exemption” or generate efficiencies that justify their anticompetitive effects. The principal safe harbor is the Vertical Agreements Block Exemption.

Q 5.44.1 How does an agreement qualify under the Vertical Agreements Block Exemption?

The safe harbor under the VABE is based on market share. While there is apparent precision in the numbers, there are in reality many exceptions to the rule, or ambiguous circumstances. In general for the VABE to apply, the supplier's market share must not exceed 30% of the relevant market in which it sells the contract goods or services and the buyer's market share must not exceed 30% of the market on which it purchases the contract goods or services.

If the relevant market share threshold is not exceeded, the agreement will generally fall within the safe harbor unless it contains a “hardcore restriction.” These include:

- resale price maintenance (although the supplier recommending a price or imposing a maximum price is generally permitted);
- market partitioning (although generally this is permitted with regard to active sales);
- bans on passive sales, including Internet sales (sales in response to unsolicited requests from customers outside a territory or customer group allocated to the buyer); and
- certain restrictions in selective distribution arrangements.

The exception is where the European Commission decides to withdraw the benefits of the safe harbor if it considers that the agreement is nevertheless incompatible with the TFEU article 101(3) efficiency criteria. This happens rarely, but could occur, for example, where parallel networks of vertical restraints exist between competing buyers and suppliers, foreclosing a market to new entrants. Any agreement containing a hardcore restriction falls outside the safe harbor in its entirety and would need to be assessed individually under TFEU article 101. However, such agreements are presumed unlikely to fulfill the conditions of article 101(3).

Q 5.44.2 How are exclusive dealing arrangements, territorial restrictions, and other kinds of vertical arrangements with customers or suppliers treated in the EU?

These arrangements fall under the analytical framework detailed above. Hence, they benefit from the VABE safe harbor provided that the market share thresholds are met and that they do not contain hardcore restrictions.

Customer or territorial restrictions are generally considered as hardcore restrictions and, therefore, as falling outside the application of the VABE. However, there are exceptions to this. For example, active (not passive) sales restrictions in exclusive distributor agreements into the territory or to customers of another exclusive distributor or reserved by the supplier fall under the safe harbor exception, provided that the market share thresholds are met. The same is true for restrictions on active or passive sales to unauthorized distributors in a selective distribution arrangement.

Vertical agreements that fix minimum resale prices are rarely permitted under EU law, since they are regarded as hardcore restrictions on competition. There may be certain limited situations in which resale price maintenance may be permissible, but analysis here requires EU competition law expertise.

By contrast, vertical agreements that fix maximum resale prices or that recommend prices may often be permitted, since they are generally not regarded as having negative effects on competition. However, if they result in uniform prices at the maximum or recommended level,

and therefore in effect set minimum resale prices, they would constitute hardcore restrictions of competition and be prohibited. This is more likely to be the case where the supplier has a strong market position, or in oligopolistic markets, where competitors have similar cost structures, products or services are homogenous, and there is price transparency.

Q 5.45 How are vertical distribution issues treated in China?

The Chinese Antimonopoly Law⁹ prohibits “monopoly agreements,” without making an express distinction between horizontal and vertical agreements. The only kinds of vertical agreement expressly listed as prohibited for all companies are agreements to fix resale prices or to limit resale prices.¹⁰ A recent court case requires proof of effect of restricting or eliminating competition in a resale price maintenance case.¹¹ Other types of vertical agreements may be caught by the general prohibition on anticompetitive agreements even if they are not expressly listed in the AML.

Monopoly agreements (including vertical agreements such as resale price maintenance agreements) can be exempted from prohibition if they are proven to have certain beneficial purposes, such as upgrading product quality, reducing cost, improving efficiency, reinforcing the competitiveness of small and medium-sized businesses, mitigating serious decreases in sales volume or excessive production during economic recessions, or for justifiable interests in foreign trade or foreign economic cooperation.¹²

The AML also expressly prohibits certain types of agreements (at least where there is no “valid justification”) involving suppliers or customers with dominant market positions. For example, such dominant firms may not require trading partners to agree to exclusive dealing or tying arrangements, impose “other unreasonable trading conditions,” or engage in differential treatment of similar counterparties.¹³

Finally, Chinese contract law and related regulations prohibit several types of IP licensing provisions that may be common in other jurisdictions, including exclusive dealing, grant-back requirements, and non-challenge clauses. Contracts containing such provisions may be rendered invalid and unenforceable.¹⁴

China's antitrust regime is young and still evolving, so it is difficult to describe with confidence how particular activities will be judged. The identity of the parties may still have an effect in particular cases, and Chinese antitrust authorities have considerable discretion to interpret and apply the relevant statutes and regulations.

Q 5.46 How are vertical distribution issues treated in Japan?

In Japan, vertical restraints are mainly regulated as unfair trade practices, which include, among other things, refusal to deal, discriminatory pricing, predatory pricing, resale price maintenance, exclusive dealing, and tying. Unfair trade practices originally were derived from section 5 of the FTC Act, but the Japanese antitrust law identifies specific types of conduct which fall within unfair trade practices.

The Japanese Fair Trade Commission has promulgated guidelines on distribution and business practices, which provide useful guidance on the treatment of vertical distribution restrictions.¹⁵ The guidelines emphasize that resale price maintenance agreements constitute unfair trade practices, because they reduce or eliminate price competition among distributors. While suggested resale prices are not in themselves unlawful, any attempt to cause retailers to adhere to suggested prices will be regarded as resale price maintenance in principle and, thus, unlawful.¹⁶ Although it is not theoretically incorrect, unreasonable restraint of trade mainly applies to horizontal restraints because of the requirement of "mutual restriction or conduct." Vertical distribution issues are almost always regulated as unfair trade practices.

Notes

1. Fed. Trade Comm'n v. Mylan Labs., Inc., 62 F. Supp. 2d 25 (D.D.C. 1999).
2. Toys "R" Us, Inc. v. Fed. Trade Comm'n, 221 F.3d 928 (7th Cir. 2000).
3. Seaboard Supply Co. v. Congoleum Corp., 770 F.2d 367, 374 (3d Cir. 1985).
4. United States v. Delta Dental of R.I., 943 F. Supp. 172 (D.R.I. 1996).
5. State Oil Co. v. Kahn, 522 U.S. 3 (1997).
6. Leegin Creative Leather Prods., Inc. v. PSKS, Inc., 551 U.S. 877 (2007).
7. United States v. Colgate & Co., 250 U.S. 300 (1919).
8. Treaty on the Functioning of the European Union (2007) (consolidated version), 2010 O.J. (C 83) 47.
9. Antimonopoly Law of the People's Republic of China (promulgated by the Standing Committee of the National People's Congress, Aug. 30, 2007, effective Aug. 1, 2008) (China) [hereinafter AML].
10. AML art. 14.
11. First Case Involving Vertical Monopoly Agreement Decided (May 19, 2012), available at http://rmfyb.chinacourt.org/paper/page/1/2012-05/19/03/2012051903_.pdf (in Chinese).
12. AML art. 15.
13. See, e.g., AML art. 17.
14. See Contract Law arts. 329, 343 (China); PRC Supreme People's Court Interpretation Concerning Certain Issues in Adjudication of Disputes over Technology Contracts (Dec. 16, 2004); Regulation on Administration of Import and Export of Technologies (Dec. 10, 2001) (relating to technology transfers into or out of China).
15. Japan Fair Trade Commission, Guidelines Concerning Distribution Systems and Business Practices Under the Antimonopoly Act (July 11, 1991), available at www.jftc.go.jp/en/legislation_gls/imonopoly_guidelines.files/distribution.pdf.
16. *Id.* pt. II, ch. 1.

