VI. VERTICAL RESTRAINTS

A. Overview

"Vertical" restraints are restrictive provisions in agreements between entities at different levels of the supply chain, like those between a manufacturer and a retailer, or between a component supplier and an original equipment manufacturer. They are more common, and less likely to be harmful under most circumstances, than horizontal restraints. After all, most companies have more reasons (at least, more good and procompetitive reasons) to enter into agreements with their trading partners than with their competitors!

But this does not mean that vertical agreements are invariably benign. On the contrary, the imposition of restrictive obligations on one's trading partners can be a powerful means of excluding rivals or even facilitating collusion. In this chapter we will focus on some of the ways in which this may occur.

Anticompetitive vertical restraints were among the concerns raised during the early years of the Sherman Act. Practices that attracted scrutiny included: exclusivity commitments that prohibited trading partners of one party from dealing with that party's competitors; "tying" agreements that committed the buyer of a primary product or service to buy a secondary product or service as well; so-called "vertical price-fixing" agreements between a manufacturer and a retailer regarding downstream retail prices (what we would now call "resale price maintenance," or just "RPM"); most-favored-nation ("MFN") agreements, which guaranteed that the beneficiary would receive terms at least as favorable as those offered to its rivals; agreements which guaranteed "discriminatory" preferred treatment from a trading partner (that is, *better* than the terms offered to rivals: what we would now call "MFN-plus" agreements); and a variety of other vertical practices. For example, the famous *Standard Oil* decision of 1911 concerned, among (many) other things, allegations that Standard Oil had obtained "[r]ebates, preferences, and other discriminatory practices" from railroads.[382]

At certain times in the history of antitrust, judicial treatment of vertical restraints has been strongly influenced by concerns about exploitation of power asymmetries, the domination of a weaker party by a stronger, and discrimination (in the sense of dissimilar treatment of trading partners). In particular, a number of earlier cases expressed the view that the freedom and independence of trading partners, including small businesses, ought not to be fettered by an obligation imposed by a more powerful trading partner.[383] This theme is exemplified by a passage in the district court's opinion in the 1951 *Richfield Oil* case:

> Richfield cannot, by creating the relationship of landlord and tenant, long and anciently known to our law, with all the responsibilities that such relationship imposes on the transferee, restrain trade through that outlet by imposing illegitimate oral contacts which restrict the transferee to the handling of Richfield's products or Richfield's sponsored products. . . . It follows that the . . . operators are, by the instrument of their creation, independent business men, as that concept is understood in anti-trust law, and that the imposition on them by oral agreements of restrictive conditions limiting their dealings to Richfield products and Richfield sponsored . . . products, and denying access to other dealers in petroleum and accessories to these stations, and, through

[382] Standard Oil Co. of New Jersey v. United States, 221 U.S. 1, 42–43 (1911).

[383] *See, e.g.*, Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. 36, 66–67 (1977) (White, J., concurring in the judgment) ("[I]ndependent businessmen should have the freedom to dispose of the goods they own as they see fit."); United States v. Arnold, Schwinn & Co., 388 U.S. 365, 378–79 (1967) (holding that remedy should ensure "freedom of distributors to dispose of the [defendant's] products, which they have bought from [the defendant], where and to whomever they choose," and stating that "[u]nder the Sherman Act, it is unreasonable without more for a manufacturer to seek to restrict and confine areas or persons with whom an article may be traded after the manufacturer has parted with dominion over it"); Dr. Miles Medical Co. v. John D. Park & Sons Co., 220 U.S. 373, 407–08 (1911) (noting the "freedom of trade on the part of dealers who own what they sell"); GTE Sylvania Inc. v. Continental T.V., Inc., 537 F.2d 980, 1019–29 (9th Cir. 1976) (Browning, J., dissenting) (extended and detailed discussion of the "statutory policy [under the Sherman Act] of protecting the independence of individual business units").

> them, to the public, is violative of both Section 1 of the Sherman Anti-Trust law and Section 3 of the Clayton Act.[384]

But these concerns are largely absent from modern law. Since the 1970s, courts have focused antitrust analysis—including in vertical restraint cases—on the creation and maintenance of market power in ways that harm consumers, rather than on power asymmetries, commercial freedom, or discrimination.[385]

Through that lens, lawyers and economists today appreciate that vertical restraints may harm consumers and competition in a variety of ways.[386] A central concern is that they may do so by "foreclosing" (*i.e.*, restricting) rivals' access to important inputs, distribution, customers, or complements. Such foreclosure might enable a defendant to impair its rivals' effectiveness, or raise their costs, and gain additional pricing power as a result, leading to consumer harm.[387] For example, if a monopolist locked up key input suppliers or distributors through exclusive deals, the monopolist's competitors might be forced to switch over to higher-priced, lower-quality alternatives that would raise their costs and weaken their ability to compete with the monopolist, enabling the monopolist to raise its prices. In extreme cases, rivals might be forced out of the market entirely.

Foreclosure is not the only way in which a vertical restraint might result in consumer harm. Vertical restraints may also soften competition by facilitating coordination among competitors. For example, competitors aiming to generate or facilitate tacit collusion might introduce parallel vertical restraints (such as MFN commitments to customers, which we will discuss below) as a way of committing to rivals that they will not engage in aggressive discounting.[388] Vertical restraints may also diminish "intrabrand" competition among distributors of a single product (*e.g.*, by directing them all to charge the same price), although as we will see that has become a minimal concern in modern law.

The standard of review for vertical restraints has changed over time, in light of changing views about the economics of vertical coordination and about the nature and purpose of the antitrust project as a whole. For much of the 20th century, vertical restraints in a number of categories—including minimum RPM, maximum RPM, and tying agreements—were *per se* illegal, just as price-fixing agreements are today.[389] But this rule came under considerable

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[384] *See*, *e.g.*, United States v. Richfield Oil Corp., 99 F. Supp. 280, 293–94 (S.D. Cal. 1951). For a contemporaneous perspective, *see also* Thomas E. Kauper, *The "Warren Court" and the Antitrust Laws: of Economics, Populism, and Cynicism*, 67 Mich. L. Rev. 325, 332 (1968) ("Apparently uncertain about the effect of such vertical arrangements upon concentration in the market and not confident that in all cases such effects can be determined on a case-by-case basis, the Court has proceeded with a method of analysis placing primary emphasis on equality of opportunity, free access to markets by competing sellers, and complete freedom of choice by buyers. If it can be proved that the challenged practice is likely to increase concentration or create high barriers to entry, so much the better. But in any event, the practice may be condemned as an unwarranted limitation on buyer and/or seller opportunities.").

[385] For early harbingers, *see*, *e.g.*, Albrecht v. Herald Co., 390 U.S. 145, 158 (1968) (Harlan. J., dissenting) ("It has long been recognized that one of the objectives of the Sherman Act was to preserve, for social rather than economic reasons, a high degree of independence, multiplicity, and variety in the economic system. Recognition of this objective does not, however, require this Court to hold that every commercial act that fetters the freedom of some trader is a proper subject for a per se rule in the sense that it has no adequate provable justification."); Dr. Miles Medical Co. v. John D. Park & Sons Co., 220 U.S. 373, 412 (1911) (Holmes, J., dissenting) ("[I]t seems to me that the point of most profitable returns marks the equilibrium of social desires, and determines the fair price in the only sense in which I can find meaning in those words. The Dr. Miles Medical Company knows better than we do what will enable it to do the best business. . . . I cannot believe that in the long run the public will profit by this court permitting knaves to cut reasonable prices for some ulterior purpose of their own, and thus to impair, if not to destroy, the production and sale of articles which it is assumed to be desirable that the public should be able to get.").

[386] *See*, *e.g.*, Dennis W. Carlton & Ralph A. Winter, *Vertical Most-Favored-Nation Restraints and Credit Card No-Surcharge Rules*, 61 J. L. & Econ. 215 (2018); Claudia M. Landeo, *Exclusionary Vertical Restraints and Antitrust: Experimental Law and Economics Contributions* in Kathryn Zeiler & Joshua Teitelbaum (eds.), THE RESEARCH HANDBOOK ON BEHAVIORAL LAW AND ECONOMICS (2015); Steven C. Salop, *Economic Analysis of Exclusionary Vertical Conduct: Where Chicago Has Overshot the Mark* in Robert Pitofsky (ed.) HOW THE CHICAGO SCHOOL OVERSHOT THE MARK: THE EFFECT OF CONSERVATIVE ECONOMIC ANALYSIS ON U.S. ANTITRUST (2008).

[387] The classic statement is Thomas G. Krattenmaker & Steven C. Salop, *Anticompetitive Exclusion: Raising Rivals' Costs to Achieve Power over Price*, 96 Yale L.J. 209 (1986).

[388] Jonathan B. Baker & Judith A. Chevalier, *The Competitive Consequences of Most-Favored-Nation Provisions*, 27 Antitrust 20, 22–23 (Spring 2013) ("The most immediate and direct significance of an MFN for the seller, and the source of competitive harms from facilitating coordination and dampening competition, is to raise the seller's cost of cutting price to buyers other than the buyer that is the beneficiary of the MFN. . . . To see why a tax on price-cutting facilitates coordination, suppose that coordinated conduct in this industry is inhibited by suppliers' incentives to cheat—that is, deterring cheating is the 'cartel problem' the bottle makers have to solve to make coordination possible or more effective. A bottle maker that adopts an MFN with some or all customers helps the industry solve that problem by tying its own hands.").

[389] *See*, *e.g.*, Dr. Miles Medical Co. v. John D. Park & Sons Co., 220 U.S. 373 (1911) (minimum RPM illegal), *overruled by* Leegin Creative Leather Products, Inc. v. PSKS, Inc., 551 U.S. 877 (2007).

pressure—including, but not only, as a series of influential academic contributions in the 1950s, 1960s, and 1970s articulated some reasons why courts should pause before automatically condemning broad categories of vertical restraints.[390]

Today vertical restraints are analyzed under the rule of reason. The *per se* rule against the use of exclusive distribution territories was eliminated in the 1970s (after having been introduced in the 1960s); the *per se* rule against RPM was eliminated in two steps in 1997 and 2007 (for agreements on maximum and minimum price respectively); the *per se* rule against tying has not *quite* been formally eliminated but in practice something approaching a rule-of-reason assessment is the norm today; and the analysis of exclusive dealing has required a rule-of-reason-style assessment since the 1960s. Thus, today, with a slight asterisk for tying arrangements, no vertical restraints are *per se* illegal.

There is a rich and thoughtful scholarly literature on the economics of vertical restraints, much of which emphasizes the importance of understanding specific markets, practices, and circumstances in judging their harmful and beneficial effects.[391] Evidence of the effects of vertical restraints is mixed and limited. [392]

The Idea of Free Riding

One important way in which some vertical restraints can help to promote competition is by deterring "free riding." This is a recurrent idea in discussions of vertical restraints. The core point is that businesses may be deterred from investing in the supply or improvement of a product or service if their rivals are able to appropriate the benefits of those investments: and, conversely, that businesses may invest more fully in competition if they are allowed to protect their investments from appropriation by rivals. One way to do so is through vertical contracts.[393]

To make this more concrete with an example, suppose that a device OEM (original equipment manufacturer: a company that makes devices) wants to introduce a valuable new feature into its device, and in order to do this it must cooperate closely with some upstream component manufacturers. Suppose that the OEM knows that developing the new feature will involve a major investment of money and resources in R&D, and will involve sharing the fruits of that R&D activity—and perhaps other proprietary information—with the component manufacturers. Now, if the component suppliers are then free to share the benefits of the investment with other, competing OEMs, then the original OEM's investment might end up subsidizing its direct competitors, giving rivals the benefit of the expensive R&D without any of the costs. And the OEM knows all this in advance, when it is deciding whether, and how much, to invest. Its reluctance to subsidize rivals may discourage investment. But if the OEM can require, as a precondition of participation in the project, a period of exclusivity in which the component suppliers will not work with rivals in particular ways, the OEM's incentive to undertake and invest in this project can be preserved. Conversely, if the exclusivity commitment is impossible (*e.g.*, because it is forbidden by the antitrust laws), the incentive will be reduced, leading to less investment and innovation. A valuable new feature may never be developed.

Of course, the fact that "free riding" may threaten or soften investment incentives does not mean that a free-riding concern is, or should be, a hall pass for any conceivable form of restriction. For one thing, free riding may not be

[390] *See*, *e.g.*, Lester G. Telser, *Why Should Manufacturers Want Fair Trade?* 3 J. L. & Econ. 86 (1960) (resale price maintenance); Ward S. Bowman Jr., *Tying Arrangements and the Leverage Problem*, 67 Yale L.J. 19 (1957); Aaron Director & Edward H. Levi, *Law and the Future: Trade Regulation*, 51 Nw. U. L. Rev. 281, 290 (1956) (single monopoly profit theorem, briefly stated).

[391] *See*, *e.g.*, Patrick Rey & Thibaud Vergé, *Economics of Vertical Restraints* in Paolo Buccirossi (ed.), HANDBOOK OF ANTITRUST ECONOMICS (2008); Daniel P. O'Brien, *The Antitrust Treatment of Vertical Restraints: Beyond the Possibility Theorems* in Konkurrensverket (Swedish Competition Authority), THE PROS AND CONS OF VERTICAL RESTRAINTS (2008); B. Douglas Bernheim & Michael D. Whinston, *Exclusive Dealing*, 106 J. Pol. Econ. 64 (1998).

[392] *See* Francine Lafontaine & Margaret Slade, *Exclusive Contracts and Vertical Restraints: Empirical Evidence & Public Policy* in Paolo Buccirossi (ed.), HANDBOOK OF ANTITRUST ECONOMICS (2008) (noting that, while over one third of retail sales through independent retailers is subject to some form of exclusivity, there are "very few" empirical studies of the effects of vertical restraints).

[393] *See*, *e.g.*, Ward S. Bowman, *The Prerequisites and Effects of Resale Price Maintenance*, 22 U. Chi. L. Rev. 825, 835 (1955) (RPM as a response to free riding concerns).

a serious concern in a particular case[394]; for another, the mere existence of a directional free-riding threat does not mean that a restraint designed to block it is actually net-beneficial to consumers![395] In the example above, for example, it is not at all clear whether the harm from exclusivity will outweigh the benefits from the extra innovation and investment. It is also worth remembering that "free riding"—that is, the receipt of unpriced benefits from the investments of others—is ubiquitous, including through competition's core mechanic of competitive imitation.[396] The world would surely not be a better place, all things considered, if all free riding were prohibited![397]

A central feature of vertical-restraint law is the distinction between "interbrand" restraints (that is, in the classic form, restraints imposed by a producer on trading partners' ability to deal in the products of *other* manufacturers) and "intrabrand" restraints (that is, restraints imposed by a producer on the distribution of its *own* product as part of a distribution strategy). Modern antitrust is much more worried about the former than the latter. As we will see, in general, pure intrabrand restraints are of little or no concern today: as Eleanor Fox has put it, "firms have no duty to create or tolerate competition in their own product, and if they impose territorial restraints in the course of distributing their product, those restraints are presumed to be efficient for the firm and efficient or at least neutral for competition and consumers."[398] We will consider intrabrand and interbrand restraints separately below.

Antitrust's turn away from *per se* bans on certain vertical practices has attracted some controversy, particularly in light of the difficulty that plaintiffs often face in mounting a rule of reason case (see Chapter IV). Today, at the broadest level, we can think of three general schools of thought on vertical restraints: first, a general "Chicago School" view that they should be *per se* legal or nearly so; second, a view that we should return to the broad-brush bans of earlier decades rather than mire the courts in difficult effects analyses; and, third, a view (reflecting, for the most part, current law) that vertical restraints can generate both significant benefits and significant harms, and that courts should navigate on a case-by-case basis, with the focus on interbrand restraints that harm consumers.

The following extracts briefly illustrate these perspectives. We start with Judge Frank Easterbrook—one of the leading figures of antitrust's Chicago Revolution—proposing *per se* legality for what he calls "distribution restraints."[399]

Frank Easterbrook, Vertical Arrangements and the Rule of Reason

53 Antitrust L.J. 135 (1984)

I want to make a point as simple as it is controversial. No practice a manufacturer uses to distribute its products should be a subject of serious antitrust attention. It should make no difference whether the manufacturer prescribes territories, customers, quality standards, or prices for its dealers. It should make no difference whether the manufacturer "ties" products together in a bundle, employs full-line forcing or exclusivity clauses, or uses

394 *See*, *e.g.*, Warren S. Grimes, *The Sylvania Free Rider Justification for Downstream-Power Vertical Restraints: Truth or Invitation for Pretext?* in Robert Pitofsky (ed.), HOW THE CHICAGO SCHOOL OVERSHOT THE MARK: THE EFFECT OF CONSERVATIVE ECONOMIC ANALYSIS ON U.S. ANTITRUST (2008); *see also* Toys "R" Us, Inc. v. FTC, 221 F.3d 928, 933 (7th Cir. 2000) ("The Commission also considered the question whether [Toys R Us ("TRU")] might have been trying to protect itself against free riding, at least with respect to its vertical agreements. . . . Nevertheless, it found that the manufacturers compensated TRU directly for advertising toys, storing toys made early in the year, and stocking a broad line of each manufacturer's toys under one roof. A 1993 TRU memorandum confirms that advertising is manufacturer-funded and is 'essentially free.'").

395 *See*, *e.g.*, Gregory T. Gundlach, Joseph P. Cannon & Kenneth C. Manning, *Free riding and resale price maintenance: Insights from marketing research and practice*, 55 Antitrust Bull. 381 (2010); George A. Hay, *The Free Rider Rationale and Vertical Restraints Analysis Reconsidered*, 56 Antitrust L.J. 27 (1987).

396 *See*, *e.g.*, Brett M. Frischmann & Mark A. Lemley, *Spillovers*, 107 Colum. L. Rev. 257 (2007); Wendy J. Gordon, *On Owning Information: Intellectual Property and the Restitutionary Impulse*, 78 Va. L. Rev. 149 (1992). *See generally* Philippe Fontaine, *Free Riding*, J. Hist. Econ. Thought 359 (2015); Orly Lobel, TALENT WANTS TO BE FREE: WHY WE SHOULD LEARN TO LOVE LEAKS, RAIDS, AND FREE RIDING (2013); Richard Tuck, FREE RIDING (2008).

397 *See* Kal Raustiala & Christopher Sprigman, THE KNOCKOFF ECONOMY: HOW IMITATION SPARKS INNOVATION (2012).

398 Eleanor M. Fox, *Parallel Imports, The Intrabrand/Interbrand Competition Paradigm, and the Hidden Gap Between Intellectual Property Law and Antitrust*, 25 Fordham Int'l L.J. 982, 982 (2002).

399 A similar view can be found in Richard A. Posner, *The Next Step in the Antitrust Treatment of Restricted Distribution: Per Se Legality*, 48 U. Chi. L. Rev. 6 (1981).

"reciprocity." It should make no difference whether the restrictions are set by contract or by manufacturers' ownership of the retail outlets, the most "extreme" form of control. They are all the same.

This is not a radical proposal. Most of these practices, which I lump under the term "restricted dealing," are in common use. All of them except the prescription of prices and tying are dealt with under a highly deferential standard of review and are lawful except in the rarest of cases. The treatment of prices and tying is an anomaly that should be brought in line with the treatment of vertical integration and other restrictions on distribution.

If restricted dealing arises out of a cartel among dealers or manufacturers, by all means let us prosecute. Cartels are unlawful per se and should remain so. But restricted dealing is not often used by cartels, and most restricted dealing is just a way by which one manufacturer competes with others. Our economy has many ways of assembling and distributing products. The more routes to market, the broader the consumers' choice. The broader their choice, the better off they are. Cartels restrict rather than increase the range of choice. We should welcome restricted dealing as a benefit to consumers and not lump it with cartels, with which it has nothing in common.

. . . [M]ost forms of restricted dealing could be anticompetitive in one manifestation or another. But so too could the charging of low prices or the opening of new plants. There are limits on the ability of courts to sort the beneficial from the deleterious manifestations of these practices, and most of the time it is better not to try than to try and fail. [. . .]

Why . . . would cooperative agreements in the chain of distribution be subject to antitrust scrutiny? The usual argument for prohibition is that restricted dealing is "like" a cartel in the sense that firms agree on price (or quality, or place of distribution). True enough. But one can find such agreements inside every firm too. The fact that two practices have such a feature in common is just the beginning of analysis. This holds, too, for the subsidiary rationale used to attack ties, exclusive distribution and reciprocity: that these "extend" a monopoly from one market to another. Perhaps they do. But they can do this only if there is a monopoly to start with, and even then there will be difficult questions about whether the "extension" is profitable to the firm or harmful to consumers. One must look further.

Before going on, I want to dispatch a line of argument one hears too often in political discourse. It is that restricted dealing, and especially resale price maintenance, is bad because it enables manufacturers to jack up the retail price of its products. So it does. Resale price maintenance is no different in this respect from other restrictions (for example, if there are fewer dealers, each can charge more).

So what? If Russell Stover wants its chocolates to sell for $20 per pound, it can achieve this easily enough. It may raise the wholesale prices. It may improve or change the product's quality or style, so that it tastes better than Godiva. The observation that these things influence retail prices is not even interesting as an antitrust concern. Every manufacturer may sell what it wants and charge what the traffic will bear. Other manufacturers, perhaps using less chocolate per pound or employing more efficient manufacturing, may sell different goods and charge less. This is competition. Consumers will choose. The question is whether restricted dealing affects price in an anticompetitive way. If manufacturers may affect retail prices by changing wholesale prices or quality, why may they not affect prices through restricted dealing?

The argument must be that restricted dealing can facilitate a real cartel, such as an agreement among manufacturers or dealers to charge an elevated price. One of the cartel arguments might run like this: Dealers—say, druggists—in some city collude to drive up the price of toothpaste. Each dealer is worried that the others will "cheat," that is, that other dealers will reduce the price in order to make additional sales at the expense of these adhering to the fixed price. So the dealers conscript the manufacturers to help them out. The manufacturers set a fixed resale price and penalize dealers that sell at a lower price.

The argument that restricted dealing is a way of enforcing a dealers' cartel conceals substantial problems. First, the industry must be one in which the dealers can form a cartel. But when will this be? Most retail markets have free entry, and retailing is about as close to an atomistic market as you can get. There is a drug store on every other corner. There are so many retailers (and potential retailers) of toothpaste and other consumer goods that the firms could not form or sustain a cartel with or without the aid of manufacturers.

As for the manufacturers: Why go along? What's in it for them? A manufacturer that helps dealers form a cartel is doing itself in. It will sell less, and dealers will get the monopoly profits. Manufacturers could be 'paid' in higher wholesale prices for cooperating, but that would increase the incentives of dealers not to join the cartel—to cheat by buying the product at a lower price and selling on a lower margin. If significant numbers of dealers cheat, bye-bye cartel. [. . .]

. . . [T]he dealers' cartel explanation won't amount to much unless there are (1) few dealers; (2) few manufacturers; (3) homogeneous products; and (4) easy policing. If we see many dealers and many manufacturers, we can exclude the cartel possibility. And if we see some manufacturers using restricted dealing while others do not, or if we see substantially differentiated products, we can exclude the cartel hypothesis no matter how many or few dealers and manufacturers there are.

. . . Because the conditions under which restricted dealing is anticompetitive are so rare, automatic condemnation would pick up far too many procompetitive examples to be worthwhile.

Why Would Trading Partners Ever Accept Anticompetitive Restraints?

The prospect of harmful vertical restraints presents an economic puzzle that was prominently emphasized by Chicago School writers in the 70s and 80s. If a particular vertical restraint—let's say, an exclusivity commitment made by distributors or suppliers to a trading partner with market power—is truly harmful to competition, why would the distributors or suppliers ever agree to it, thus making their own lives worse by contributing to market power? Isn't it more likely—the argument goes—that if a distributor or supplier accepts a restraint, it's because the parties have figured out that the restraint is part of an overall efficient arrangement?[400]

Subsequent writers have identified some answers to this question. One of the most prominent responses focuses on the existence of a "collective action problem"—that is, a situation involving multiple participants, in which the unilateral self-interested act of each participant leads to an outcome that is overall worse for everyone.[401] In the context of vertical restraints, a collective action problem can show up in something like the following way.

Suppose that there is a manufacturer with monopoly power, and four distributors of identical size and scale in competition with one another downstream. The manufacturer fears competitive entry from a potential entrant. It offers its distributors a deal: commit to deal with me exclusively and I will give you a 10% discount. Each distributor now thinks: well, if the potential entrant manages to enter the market, I could get a competitive price that's even lower than the discounted deal that the monopolist is offering me.

But the distributor will then try to figure out whether the rival will be able to successfully enter, including whether the entrant would be competitively viable with the business of just one distributor. If the business of one distributor would be enough to support the entrant, then each distributor would know that it could unilaterally make sure the rival entered successfully. This would give each distributor the confidence to decline the monopolist's offer of a discount in exchange for exclusivity: the scheme would fail.

But if the entrant needed the business of *two or three* distributors to make its entry successful, things could work out very differently. Each distributor knows that if it declines the monopolist's offer and bets on working with the entrant instead, it cannot alone guarantee that the entrant will be successful: and if entry does not in fact take place the distributor that turned down the monopolist will get hammered by its competitors who did take the 10% discount. Thus, each distributor will unilaterally take the deal from the monopolist, even if all the distributors collectively would be better off if they did not. This is the collective action dynamic that helps to explain why trading partners might agree to deals that end up making things worse for them.

[400] *See, e.g.*, Robert H. Bork, THE ANTITRUST PARADOX: A POLICY AT WAR WITH ITSELF (1978) 309 ("A seller who wants exclusivity must give the buyer something for it. If he gives a lower price, the reason must be that the seller expects the arrangement to create efficiencies that justify the lower price.").

[401] *See, e.g.*, Eric B. Rasmusen, J. Mark Ramseyer, John S. Wiley Jr., *Naked Exclusion*, 81 Am. Econ. Rev. 1137 (1991). There are other possible explanations too. For example, some trading partners may do better by accepting exclusivity in exchange for a share of monopoly profits than under upstream competition. *See, e.g.*, Joseph Farrell, *Deconstructing Chicago on Exclusive Dealing*, 50 Antitrust Bull. 465, 477 (2005).

A clever monopolist can exploit this collective-action dynamic more effectively: for example, by asking for long-term exclusivity commitments that come up for renewal at staggered intervals, so that whenever any individual distributor faces the question, all its rivals are locked into exclusivity and are unavailable to help support competitive entry or expansion.

At the other end of the spectrum from the "Chicago School" view that vertical practices—or at least broad categories of such practices—should be left entirely alone by courts, the Open Markets Institute and other groups and individuals petitioned the FTC in July 2020 to ban certain vertical restraints entirely.[402] Note that where the Easterbrook extract above focused primarily on "intrabrand" distribution restraints; the petition extract presented below is aimed at vertical agreements with some interbrand effects.

Petition for Rulemaking to Prohibit Exclusionary Contracts by Open Markets Institute et al.

(F.T.C., filed July 21, 2020)

Vertical restraints are an instrument by which corporations can control less powerful economic actors. Through contract and contract-like arrangements, a powerful manufacturer can restrict the autonomy of a distributor, limiting its freedom to select trading partners and the terms on which it sells its goods. For instance, under exclusive dealing, a manufacturer can bar its distributors from handling the products of manufacturing rivals and prohibit suppliers from selling inputs to competing manufacturers. McDonald's founder Ray Kroc described, and indeed boasted, about how McDonald's controlled franchisees through contract, stating "the only way we can positively know what these [franchisees] are doing what they are supposed to do is to give them no alternative whatsoever. You can't give them an inch." Through vertical restraints, firms can vertically integrate in effect, and often shed legal responsibilities that come with traditional vertical integration through ownership and control. Historically, the Supreme Court, in interpreting the antitrust laws, limited firms' ability to dominate trading partners using vertical restraints.

The Court in [*Richfield Oil Corp v. United States*, 343 U.S. 922 (1952), *aff'g United States v. Richfield Oil Corp.*, 99 F. Supp. 280 (S.D. Cal. 1951)] held certain contract and contract-like agreements as per se illegal on the grounds that they interfere with business autonomy. {*Eds.: note that the Supreme Court in this case summarily affirmed the decision of the district court: in this paragraph the petition is quoting the district court, not the Supreme Court.*} The Court noted the general independence of businesses bound by these restraints, stating that these proprietors "in the performance of a particular contract, or in the conduct of his business, acts chiefly for himself and for his own benefit and profit, and not others and the benefit and profit of others." Vertical restraints that "exercised de facto control over these 'independent business men'" contravened antitrust law, which Congress enacted to secure "equality of opportunity." The Court subsequently affirmed the purpose of antitrust law as standing "against coercion of non-employees by vertical supply contract" in [*Simpson v. Union Oil Co. of Cal.*, 377 U.S. 13 (1964)]. The Court emphasized how the contractual agreements shift the risk and liability from the dominant firm to the subordinated firm. These agreements, in attempting to establish resale price maintenance, deprived "independent dealers of the exercise of free judgment whether to become consignees at all, or remain consignees, and, in any event, to sell at competitive prices." [. . .]

. . . [Court decisions] from the 1940s through the 1960s were rooted in an economic framework expressed in the legislative history of the antitrust laws. The drafters of the Sherman Act drew from existing common law frameworks around fair trade, economic and vocational liberty, and economic governance by workers and small firms. Denizens of 19th century America believed that a just distribution of control over one's own work would secure economic liberty and political liberty for all without fear of domination. [. . .]

Given the real evidence of harm from certain exclusionary contracts and the specious justifications presented in their favor, the FTC should ban exclusivity with customers, distributors, or suppliers that results in substantial market foreclosure as per se illegal under the FTC Act. The present rule of reason governing exclusive dealing by

[402] For a discussion of the FTC's rulemaking power, *see infra* Chapter XI.

all firms is infirm on multiple grounds. Through rulemaking, the FTC should hold that such exclusivity is an unfair method of competition. The substantial foreclosure test is consistent with the rule announced by the Supreme Court in [*Standard Oil Co. of California v. United States*, 337 U.S. 293 (1949)] (hereafter "*Standard Stations*"), a case concerning Section 3 of the Clayton Act. To offer guidance, the FTC should articulate what "substantial foreclosure" means and define it in relation to:

1) The power of the firm or firms using exclusivity,

2) The fraction of customers, distributors, or suppliers bound by exclusivity, or

3) The significance of the customers, distributors, or suppliers bound by exclusivity.

This rule would clarify the law on exclusive arrangements, encouraging dominant firms to compete on the merits and allowing most firms to use exclusivity in their contracts.

While enforcers can and have successfully challenged exclusive arrangements under the rule of reason, this prevailing legal standard has multiple deficiencies. First, the rule of reason, with its fact-intensive inquiry, is a poor analytical fit for exclusionary contracts by dominant firms. The harms from exclusionary contracting and related practices are real and documented whereas the justifications are of especially limited relevance to dominant firms. Accordingly, antitrust law should heavily restrict the practice. Second, the rule of reason, by placing most of the legal burdens on the plaintiff, requires the government and other enforcers to devote excessive time and resources to developing and litigating a case. Because of these burdens, an antitrust lawsuit under the rule of reason is extraordinarily difficult to prosecute and win. Indeed, the record suggests that the rule of reason approximates a standard of practical legality. In practice, the rule of reason means that dominant firms can use exclusionary and other unfair competitive practices without the fear of significant legal consequences.

Third, even as the rule of reason frees large corporations with sophisticated counsel to engage in exclusionary contracting, it offers little guidance to risk-averse businesses that cannot spend substantial sums on outside counsel. While it offers some markers on when exclusive dealing may violate the Sherman Act, the rule of reason does not provide prospective clarity to a firm that wants to use exclusivity for beneficial or innocuous ends. [. . .]

Drawing on *Standard Stations*, the FTC should hold that exclusive arrangements that result in substantial foreclosure of customers, distributors, or suppliers are per se illegal under the FTC Act. [. . .]

Substantial foreclosure should be satisfied through one of three ways. First, a firm with a share of 30% or more of a relevant market and that uses exclusivity with all its customers, distributors, or suppliers of an essential input engages in substantial foreclosure ("dominance test"). [. . .]

Second, a firm that uses exclusivity with customers, distributors, or suppliers of a particular input together accounting for 30% or more of their relevant market engages in substantial foreclosure ("quantitative foreclosure test"). [. . .]

Third, a firm that ties up the top three or more customers, distributors or suppliers in a concentrated market through exclusivity engages in substantial foreclosure ("qualitative foreclosure test").

* * *

Other perspectives reject both *per se* legality and *per se* illegality, and embrace rule-of-reason weighing for vertical restraints. The following extract is a good example. In it, Steve Salop explains why exclusivity agreements can present serious competitive concerns (despite arguments that competition for exclusive-partner status will usually provide enough competitive discipline) as well as the possibility of meaningful benefit.

Steven C. Salop, The Raising Rivals' Cost Foreclosure Paradigm, Conditional Pricing Practices, and the Flawed Incremental Price-Cost Test

81 Antitrust L.J. 371 (2017)

Exclusive dealing, conditional pricing practices, and other exclusionary conduct can raise entrants' or existing rivals' costs by "input foreclosure," that is, by materially raising their costs or eliminating their efficient access to critical inputs. These inputs can involve manufacturing inputs, such as raw materials, intellectual property, or distribution. Distribution can be understood as an input, and raising rivals' costs of distribution can weaken their ability to serve the entire customer base and their ability and incentives to expand. For example, by excluding its rivals' access to an efficient distribution system or other input, a monopolist can reduce the rivals' ability to induce downward pricing pressure and so can permit the monopolist to maintain its monopoly power in the face of entry. [. . .]

The substantiality of input foreclosure is demonstrated most accurately by the resulting impact on the competitors' costs and output, not by the simple fraction of input suppliers that are affected. Input foreclosure can be so severe that the foreclosed rivals will exit from the market or be deterred from attempting entry. But even if a rival can cover its costs and remain viable, it will be a weaker and less efficient competitor if its distribution or other input costs are higher. A competitor will have the incentive to raise its prices and/or restrict its output when its marginal costs are increased, even if it earns enough revenue to cover its costs or even to reach minimum efficient scale.

Thus, input foreclosure is substantial if it substantially increases rivals' costs or constrains their output or ability to expand. Similar results occur if the foreclosure reduces rivals' product quality. Some commentators inappropriately focus solely on whether the foreclosure will prevent entrants or small competitors from reaching "minimum efficient scale" (MES), the output level where a firm's average costs bottom out. Others inappropriately limit their concerns solely to whether the foreclosure will prevent rivals from reaching "minimum viable scale" (MVS), the output level where a firm can turn a profit at current prices and thus survive. This narrowing of concerns is artificial and leads to false negatives and underdeterrence. The conditions under which foreclosure can reduce competition are not limited to a failure to achieve MES or MVS.

Even if a viable rival is able to reach the MES output level, its costs may be significantly raised by exclusionary conduct if it has to pay more for distribution or other inputs or if it has to use a more costly input or distribution method. In that sense, its costs also will not be truly minimized, regardless of scale. For example, even if direct distribution is feasible or substitute distributors exist, higher costs from the foreclosure will reduce efficiency and the rival's competitive impact. Similarly, even if a rival's output exceeds MVS and the competitor remains viable, bearing higher costs from the foreclosure will reduce its efficiency and the competitive constraint it provides. . . . In both cases, the excluding firm may gain the power to raise or maintain supracompetitive prices as a result. [. . .]

Customer foreclosure focuses on the impact of losing efficient access to customers, including distributor customers. Customer foreclosure by a monopolist can injure competitors and harm competition in several distinct ways. First, in the most extreme scenario, the customer base of an entrant or small rival may be limited to such a degree that it is unable to earn sufficient revenue to cover its costs and remain viable in the market. If anticipated sales likely would fall below this "minimum viable scale (MVS)," an entrant would lack an incentive to enter and an existing competitor would have the incentive to exit. Second, the entrant or competitor may remain viable, but customer foreclosure may limit its output to a low level and constrain its ability and incentive to expand profitably, by reducing its capacity or by raising its effective costs of expansion. This impact can occur even if the rival can achieve the MVS or MES output level. Third, such customer foreclosure may permit the rival to remain in the market, but may relegate it to a niche position at a low output level, where it will provide less of a constraint on the pricing of the excluding firm(s), again, even if it reaches MES. For example, a monopolist may have the incentive to maintain monopoly prices while ceding a small market share to the entrant. Or, the monopolist may reduce prices, but only to a limited extent because the constrained competitor will not pose a significant threat, or will pose less of a threat. Consumers clearly are harmed by this foreclosure that maintains higher prices. Fourth, by reducing the competitor's likely potential customer base, customer foreclosure may reduce the rival's incentives to invest and innovate over time. This can harm consumers directly. It also can weaken the monopolist's own incentives to innovate. [. . .]

The fact that one or more competitors are injured by input or customer foreclosure does not necessarily mean that market or monopoly power will be achieved or consumers will be harmed. Consumer harm may be prevented by the existence of and continued competition from a sufficient number of non-excluded competitors . . . . These other competitors might prevent the excluding firm or firms from achieving, enhancing or maintaining market (or monopoly) power. This outcome can occur if sufficient other rivals are not foreclosed from the critical input, the remaining rivals are not at a cost disadvantage, and the remaining competitors do not coordinate prices. . . . Consumer harm requires power over price, that is, the power to raise or maintain supracompetitive prices, as well as raising rivals' costs. [. . .]

Exclusive dealing and other exclusionary conduct can have procompetitive motivations and cognizable beneficial effects. The courts have long recognized the potential for cognizable efficiency benefits from conduct that forecloses rivals. In cases where there are both significant and probable harms and cognizable benefits, the two effects must be compared in order to estimate the overall, net effects on consumer welfare and the competitive process. This comparison would involve both the probability and magnitude of the opposing effects.

The efficiencies can involve a variety of mechanisms. For example, in nonmonopoly markets, buyers sometimes can use exclusives to induce more price competition among their suppliers. Exclusives potentially can reduce risk by assuring a buyer with a guaranteed source of inputs or a seller with a guaranteed outlet for its products. Exclusives can provide incentives for improved products, better service, and increased promotion. When there is competition among a number of relatively equal competitors each with its own exclusives, and no coordination, then exclusives also are on balance less likely to cause harm to competition, as opposed to exclusives adopted by a monopolist facing a new entrant.

Exclusivity by monopolists could also be procompetitive by preventing free riding. For example, a new entrant manufacturer might free ride on the advertising by the monopolist, if the retailer carries both brands and the monopolist's advertising drives consumers to the retailer . . . . A dishonest retailer might even attempt to employ bait-and-switch tactics, if selling the entrant's brand is more profitable. If a software applications developer intends to port its application to multiple platforms, it may sacrifice quality by programming for the lowest common denominator, rather than using all the capabilities of the monopoly platform.

When exclusivity is instituted by a monopolist against all of its competitors, there is a greater likelihood that the harms dominate the benefits because there is no other competition to protect consumers. The claimed efficiencies also may not be cognizable. For example, bold claims of increased "dealer loyalty" may amount to nothing more than creation of barriers to entry that maintain monopoly prices, rather than leading to product or service improvements that increase total market output and benefit consumers. Thus, it is important to analyze the efficiency claims on a case-by-case basis, taking market structure into account, rather than assuming their existence.

* * *

Vertical restraints constitute agreements between economically distinct entities—that is, conscious commitments to a common scheme[403]—and can, accordingly, be challenged under Section 1 of the Sherman Act. Section 1 will be the focus of our discussion in this chapter.

However, when a party to an anticompetitive vertical agreement holds monopoly power, the use of vertical restraints that tend to expand or maintain that power may also (or instead) be challenged under Section 2. Courts often apply similar or identical analysis under the two provisions when both apply.[404] So there is some overlap between the practices described in this chapter and those addressed in Chapter VII on monopolization.

But it is worth keeping an eye on the difference between cases in which an *agreement* is the cause of the competitive harm and those in which the source of harm is a unilateral *policy* by a monopolist rather than an agreement. For

403 Monsanto Co. v. Spray-Rite Service Corp., 465 U.S. 752, 764 (1984). *See generally supra* § IV.B. (definition of agreement)

404 *But see*, *e.g.*, United States v. Microsoft Corp., 253 F.3d 34, 70 (D.C. Cir. 2001) (en banc) (discussing differences between Section 1 and Section 2 analysis of exclusive dealing, and suggesting that liability might result under Section 2 at a lower level of foreclosure—that is, a lower level of impact upon the market—than would be required in a Section 1 case).

example, tying cases—which a supplier makes a first ("tying") product available only subject to a commitment that the purchaser will buy a second ("tied") product as well—are often challenged under Section 1. This is appropriate if the obligation to buy the tied product is grounded in an agreement. But some tying cases involve the essentially unilateral practice of a seller in deciding not to supply a tying product unless the tied product is purchased as well: and a unilateral practice of this kind is not an agreement. Likewise, in some exclusivity cases, the source of the relevant economic effect is an agreement that imposes a prohibition on, or penalty for, dealing with rivals, making Section 1 applicable. In other exclusivity cases, however, the supplier simply operates a unilateral policy of dealing only with those that do not deal with its rivals, which would fall outside of Section 1 but may implicate Section 2.[405] Keep this distinction in the back of your mind as you encounter vertical-restraint cases: remember that unilateral policies can be challenged under Section 2, while Section 1 is focused on agreements.[406]

The rest of this chapter offers a tour of the antitrust assessment of vertical restraints. Section B describes a unifying feature of most theories of harm: the requirement of market power. Section C considers a common class of vertical restraints: "intrabrand" distribution restrictions such as those imposed by a manufacturer on the sale of its products. Section D turns to exclusivity commitments: perhaps the paradigm example of a vertical restraint. Sections E and F discuss tying and bundling. Section G considers "most favored nation" or "MFN" agreements.

B. The Role of Market Power

It is generally agreed that vertical restraints are unlikely to be harmful to competition unless the participants hold some degree of market power. This is because, in the absence of market power, by definition, the participants do not have the ability to affect overall competitive conditions. A business without market power that tries to impose a harmful restraint may soon find that its trading partners simply choose to work with alternatives.[407]

For example, suppose that a small input supplier in a competitive upstream input market and a small device manufacturer in a competitive downstream device market enter into reciprocal exclusivity commitments that preclude each from dealing with competitors of the other. If reasonable alternatives to both participants are available in the market, harmful effects are unlikely: supply relationships might simply be realigned, as other market participants find new trading partners, but overall output and welfare will probably not be impaired, and consumers will not be harmed.

As you will remember from Chapter III, market power can normally be proven in either of two ways: directly (that is, by evidence of actual anticompetitive effects on competitive conditions or market outcomes like price and output) or indirectly (that is, by evidence of high shares in a defined market protected by barriers to entry).[408] But in 2018 the Supreme Court suggested, in an odd footnote in the 2018 *AmEx* decision, that plaintiffs in vertical cases may be limited to indirect proof of market power.[409]

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[405] *See, e.g.*, Lorain Journal Co. v. United States, 342 U.S. 143 (1951).

[406] *See, e.g.*, Roland Machinery Co. v. Dresser Industries, Inc., 749 F.2d 380 (7th Cir. 1984) ("One mind is not enough for a meeting of minds. The fact that Dresser was hostile to dealers who would not live and die by its product . . . and acted on its hostility by canceling a dealer who did the thing to which it was hostile, does not establish an agreement, but if anything the opposite: a failure to agree on a point critical to one of the parties.").

[407] *See, e.g.*, Daniel A. Crane, *Market Power Without Market Definition*, 90 Notre Dame L. Rev. 31 (2014) ("Market power is an indispensable element in all antitrust cases except for those arising under the Sherman Act's rule of per se illegality."); Muenster Butane, Inc. v. Stewart Co., 651 F.2d 292, 298 (5th Cir. 1981) ("A requirement that plaintiff prove market power in this case would have saved the litigants and the courts much expense. Stewart . . . had no market power in Gainesville. The market was highly competitive. Whatever vertical restraints Stewart imposed on its dealers, their effect could not have been to raise the price consumers paid for television sets.").

[408] *See supra* § III.E.

[409] Ohio v. Am. Express Co., 585 U.S. 529, 543 n.7 (2018) ("The plaintiffs argue that we need not define the relevant market in this case because they have offered actual evidence of adverse effects on competition—namely, increased merchant fees. We disagree. The cases that the plaintiffs cite for this proposition evaluated whether horizontal restraints had an adverse effect on competition. *See* [FTC v.] Indiana Federation of Dentists, 476 U.S. 447, 450–451, 459 (1986) (agreement between competing dentists not to share X rays with insurance companies); Catalano, Inc. v. Target Sales, Inc., 446 U.S. 643, 644–645, 650 (1980) (agreement among competing wholesalers not to compete on extending credit to retailers). Given that horizontal restraints involve agreements between competitors not to compete in some way, this Court concluded that it did not need to precisely define the relevant market to

The meaning of this footnote is not clear. On the one hand, it could be read narrowly to simply underscore the basic reality that a plaintiff in an antitrust case must at least provide a rough or directional sketch of the relevant zone of competition. This reading could reflect, among other things, an assumption that the Supreme Court would almost certainly not reshape a core proof requirement for a major category of Section 1 cases in a brief and cryptic footnote. So understood, it would not literally foreclose the avenue of direct proof of market power through a showing of anticompetitive effects, even in vertical cases, and it would not require that a plaintiff furnish a technically pristine market definition. On the other hand, the footnote could be read more literally and broadly to impose a genuine requirement that a plaintiff in a vertical case cannot show market power through direct proof, and must instead plead and prove a legally sufficient market definition in every case.

As critics have pointed out, the broad reading is unappealing and anomalous. There does not seem to be much of a good reason—either in law or in economic principle—to depart from the ordinary rule that direct proof of harm, like price increases, allows a plaintiff to carry its burden.[410] Indeed, at least one lower court has assumed the continued viability of a direct-proof avenue in a vertical case, regardless of the *AmEx* footnote.[411]

C. "Intrabrand" Distribution Restraints

It is common for a business that supplies a product or service through other market participants (like retailers or distributors) to enter into agreements with them that restrict how its own product or service is sold. Restraints of this kind—imposed by a manufacturer of a product, or an entity in an economically analogous position, on the distribution of its own product—are known generally as "intrabrand" (*i.e.*, within-a-brand) restraints. This includes, for example, rules established by a television manufacturer for the distribution of its own televisions (perhaps including rules about who will be entitled to sell the televisions, how they can be displayed or sold, and at what prices). Such "intrabrand" restraints can be contrasted with "interbrand" restraints that limit the distribution of products made by *other* manufacturers (such as rules prohibiting a retailer from selling competing televisions, or limiting the conditions on which it may do so).[412] In modern law, courts and agencies generally consider intrabrand restraints to raise very low levels of competitive concern—as they do not generally hinder rival brands' ability to compete, and as modern courts do not require a manufacturer to force its own distributors to compete against each other—but in earlier periods they were treated very skeptically.

In this Section we will focus on intrabrand restraints. For many years, antitrust law divided intrabrand restraints into "nonprice" restraints and "price" restraints, with somewhat different standards applying to each at different times. Today, as we will see, the law of both nonprice and price restraints has shifted from *per se* prohibitions to a fairly lenient rule of reason. The law has not adopted the *per se* legality standard for distribution restraints that, as you have already seen, some Chicago School writers favored, but it has gone a long way in that direction.[413]

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conclude that these agreements were anticompetitive. But vertical restraints are different. *See* Arizona v. Maricopa County Medical Soc., 457 U.S. 332, 348, n. 18 (1982); Leegin Creative Leather Products, Inc. v. PSKS, Inc., 551 U.S. 877, 888 (2007). Vertical restraints often pose no risk to competition unless the entity imposing them has market power, which cannot be evaluated unless the Court first defines the relevant market. *See id.*, at 898 (noting that a vertical restraint 'may not be a serious concern unless the relevant entity has market power'); Easterbrook, *Vertical Arrangements and the Rule of Reason*, 53 Antitrust L.J. 135, 160 (1984) ('[T]he possibly anticompetitive manifestations of vertical arrangements can occur only if there is market power')."').

[410] *See*, *e.g.*, Steven C. Salop, Daniel Francis, Lauren Sillman, & Michaela Spero, *Rebuilding Platform Antitrust: Moving On from* Ohio v. American Express, 84 Antitrust L.J. 883, 896–98 (2022) (concluding that the footnote was an "unforced error," as neither the cited authorities nor "economic sense" provided a sound basis for barring the direct-proof route in vertical restraint cases); Herbert Hovenkamp, *Platforms and the Rule of Reason: The* American Express *Case*, 2019 Colum. Bus. L. Rev. 35, 46–53 (2019) (assuming the broad reading and criticizing it as "economically incoherent" and "regressive," and noting that the issue "was never briefed").

[411] Chase Manufacturing v. Johns Manville Corp., 2022 WL 522345, at *9 (D. Colo. Feb. 22, 2022) ("[T]he Court does not read [*American*] *Express* as dispensing with the direct evidence option altogether.").

[412] For a thoughtful overview of the relationship between antitrust and distribution, *see generally* Herbert Hovenkamp, THE ANTITRUST ENTERPRISE: PRINCIPLE AND EXECUTION (2005) Ch. 8.

[413] Frank Easterbrook, *Vertical Arrangements and the Rule of Reason*, 53 Antitrust L.J. 135 (1984); Richard A. Posner, *The Next Step in the Antitrust Treatment of Restricted Distribution: Per Se Legality*, 48 U. Chi. L. Rev. 6 (1981).

1. Nonprice Restraints: Territorial Restrictions

Suppliers commonly impose nonprice restrictions on how their products or services are distributed. For example, a consumer goods manufacturer might decide to have just one authorized distributor, or a limited number of such distributors, in each geographic region, or for each kind of product; similarly, a franchisor might decide to limit the number of franchisees in a particular area, or even grant that status exclusively to one franchisee. Suppliers may also establish rules for how and when their products and services are distributed.

There are a number of reasons why distribution restraints might be beneficial. For example, a manufacturer might want to make sure that its products or services are sold only through channels associated with a sufficient level of prestige, or that provide a particular type of consumer experience, to preserve the value of its brand or the quality and consistency of what buyers receive. Alternatively, a manufacturer might want its retail or distribution outlets to provide specific costly services to customers or consumers—like showrooming, customer advice, or repair—and vertical restraints may be necessary to make this work given free-riding concerns.

To illustrate, suppose that in a world of *unrestricted* distribution Retailer A had invested in providing these services in connection with the sale of Manufacturer X's goods, while Retailer B did not provide such services. By avoiding the costs of the services, Retailer B would be able to offer the manufacturer's product to consumers at a lower price. As a result, rational consumers would likely avail themselves of the services at Retailer A—for example, by examining the products at a showroom—and then buy the product from Retailer B at a lower price. This "free riding" by B on A's investments might be an unsustainable situation for Retailer A and could lead to the cessation of the services. If the free riding were sufficiently destructive, *no* retailer would end up providing the consumer services, and overall demand for the product would suffer.[414]

The manufacturer can protect against this concern through the application of nonprice restraints: for example, by giving each retailer an exclusive sales territory in which it will enjoy the full benefit of its own investments,[415] or by simply setting rules for the services retailers must provide and terminating their distribution contract (or imposing lesser penalties) if they fail to do so.[416]

Before the emergence of the modern approach in the 1970s, the Court had struggled with a rule of evaluation for restraints that limited distributors to exclusive sales areas. The leading pre-modern case was *Schwinn* in 1967, which concerned a bicycle manufacturer that sold through distributors, some of which bought and resold the bicycles to retailers, and others of which acted merely as consignees or agents, without buying the bicycles.[417] The *Schwinn* Court held that exclusive distribution territories were *per se* illegal as applied to the distributors that had bought the bicycles and were reselling them, but subject only to the rule of reason as applied to the distributors acting as consignees or agents without taking title.[418] The *Schwinn* Court explained that conclusion as follows:

> Under the Sherman Act, it is unreasonable without more for a manufacturer to seek to restrict and confine areas or persons with whom an article may be traded after the manufacturer has parted with dominion over it. Such restraints are so obviously destructive of competition that their mere existence is enough. If the manufacturer parts with dominion over his product or transfers risk of loss to another, he may not reserve control over its destiny or the conditions of its resale. To permit this would sanction franchising and confinement of distribution as the ordinary instead of the unusual method which may be permissible in an appropriate and impelling competitive setting, since most merchandise is distributed by means of purchase and sale. On the other hand . . . we are not prepared to introduce the inflexibility which a *per se* rule might bring if it were applied to prohibit all vertical restrictions of territory and all franchising,

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[414] *See supra* § VI.A.

[415] For an early recognition, *see* Richard E. Day, *Exclusive Territorial Arrangements under the Antitrust Laws—A Reappraisal*, 40 N.C. L. Rev. 223, 266–27 (1962).

[416] See Robert L. Steiner, *Manufacturers' Promotional Allowances, Free Riders and Vertical Restraints*, Antitrust Bull. 383 (1991).

[417] United States v. Arnold, Schwinn & Co., 388 U.S. 365 (1967), *overruled by* Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. 36 (1977).

[418] *Schwinn* was itself a departure from the rule-of-reason approach previously applied to nonprice restraints unconnected to resale price maintenance. *See* White Motor Co. v. United States, 372 U.S. 253, 261 (1963) ("This is the first case involving a territorial restriction in a vertical arrangement; and we know too little of the actual impact of both that restriction and the one respecting customers to reach a conclusion on the bare bones of the documentary evidence before us.").

> in the sense of designating specified distributors and retailers as the chosen instruments through which the manufacturer, retaining ownership of the goods, will distribute them to the public. Such a rule might severely hamper smaller enterprises resorting to reasonable methods of meeting the competition of giants and of merchandising through independent dealers, and it might sharply accelerate the trend towards vertical integration of the distribution process. But to allow this freedom where the manufacturer has parted with dominion over the goods—the usual marketing situation—would violate the ancient rule against restraints on alienation and open the door to exclusivity of outlets and limitation of territory further than prudence permits.[419]

Note the resonance with the earlier idea, mentioned above, that the autonomy of an "independent" trading partner was a matter of specific concern to the antitrust law of vertical restraints.[420]

But *Schwinn* did not last. It was overruled ten years later in the seminal modern case on the legality of nonprice distribution restraints: *GTE Sylvania*. In that case, the Court was invited to reconsider whether a distributor who buys and resells goods, and one who distributes on some other basis (*e.g.*, consignment), should really be treated so dissimilarly. The Court held, overruling *Schwinn*, that all nonprice distribution restraints should be assessed under the rule of reason. In so holding, the Court emphasized the distinction between "interbrand" and "intrabrand" competition, and stated that the latter was a matter of secondary concern to federal antitrust law.

GTE Sylvania (1977) was a turning point for the law of vertical restraints, just as *BMI* (1979) was a turning point in the law of horizontal collaborations between competitors. As you read *Sylvania*, notice how Justice Powell's opinion for the Court focuses on economic welfare effects: and contrast it with Justice White's concurrence in the judgment, which captures the older themes of liberty and independence. You will also see—at paragraph 5 and footnote 19 of the extract—the critical embrace of interbrand competition as the "primary concern" of antitrust law. Following this extract, you will find a passage from Judge Browning's dissent in the Ninth Circuit below, which drew heavily on these older themes to argue that the restraints should have been *per se* unlawful. Judge Browning's dissent is a striking example of the older freedom-based approach to vertical restraints: and it touches on some broader themes, including the weighing of incommensurate harms and benefits and the judicial capacity to balance economic effects with confidence. Together, the opinions show the turn in vertical restraint law—and antitrust more generally—that *Sylvania* symbolizes.

Continental T.V., Inc. v. GTE Sylvania Inc.

433 U.S. 36 (1977)

Justice Powell.

[1] Respondent GTE Sylvania Inc. (Sylvania) manufactures and sells television sets through its Home Entertainment Products Division. Prior to 1962, like most other television manufacturers, Sylvania sold its televisions to independent or company-owned distributors who in turn resold to a large and diverse group of retailers. Prompted by a decline in its market share to a relatively insignificant 1% to 2% of national television sales, Sylvania conducted an intensive reassessment of its marketing strategy, and in 1962 adopted the franchise plan challenged here. Sylvania phased out its wholesale distributors and began to sell its televisions directly to a smaller and more select group of franchised retailers. An acknowledged purpose of the change was to decrease the number of competing Sylvania retailers in the hope of attracting the more aggressive and competent retailers thought necessary to the improvement of the company's market position. To this end, Sylvania limited the number of franchises granted for any given area and required each franchisee to sell his Sylvania products only from the location or locations at which he was franchised. A franchise did not constitute an exclusive territory, and Sylvania retained sole discretion to increase the number of retailers in an area in light of the success or failure of existing retailers in developing their market. The revised marketing strategy appears to have been successful during the

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[419] United States v. Arnold, Schwinn & Co., 388 U.S. 365 (1967), *overruled by* Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. 36 (1977).

[420] *See supra* note 383 and accompanying text.

period at issue here, for by 1965 Sylvania's share of national television sales had increased to approximately 5%, and the company ranked as the Nation's eighth largest manufacturer of color television sets.

[2] This suit is the result of the rupture of a franchiser-franchisee relationship that had previously prospered under the revised Sylvania plan. Dissatisfied with its sales in the city of San Francisco, Sylvania decided in the spring of 1965 to franchise Young Brothers, an established San Francisco retailer of televisions, as an additional San Francisco retailer. The proposed location of the new franchise was approximately a mile from a retail outlet operated by petitioner Continental T. V., Inc. (Continental), one of the most successful Sylvania franchisees. Continental protested that the location of the new franchise violated Sylvania's marketing policy, but Sylvania persisted in its plans. Continental then canceled a large Sylvania order and placed a large order with Phillips, one of Sylvania's competitors.

[3] During this same period, Continental expressed a desire to open a store in Sacramento, Cal., a desire Sylvania attributed at least in part to Continental's displeasure over the Young Brothers decision. Sylvania believed that the Sacramento market was adequately served by the existing Sylvania retailers and denied the request. In the face of this denial, Continental advised Sylvania in early September 1965, that it was in the process of moving Sylvania merchandise from its San Jose, Cal., warehouse to a new retail location that it had leased in Sacramento. Two weeks later, allegedly for unrelated reasons, Sylvania's credit department reduced Continental's credit line from $300,000 to $50,000. In response to the reduction in credit and the generally deteriorating relations with Sylvania, Continental withheld all payments owed to John P. Maguire & Co., Inc. (Maguire), the finance company that handled the credit arrangements between Sylvania and its retailers. Shortly thereafter, Sylvania terminated Continental's franchises, and Maguire filed this diversity action in the United States District Court for the Northern District of California seeking recovery of money owed and of secured merchandise held by Continental.

[4] The antitrust issues before us originated in cross-claims brought by Continental against Sylvania [after Maguire's suit against Continental]. Most important for our purposes was the claim that Sylvania had violated s1 of the Sherman Act by entering into and enforcing franchise agreements that prohibited the sale of Sylvania products other than from specified locations. [. . .]

[5] The market impact of vertical restrictions is complex because of their potential for a simultaneous reduction of intrabrand competition and stimulation of interbrand competition.[19] Significantly, the Court in *Schwinn* did not distinguish among the challenged restrictions on the basis of their individual potential for intrabrand harm or interbrand benefit. Restrictions that completely eliminated intrabrand competition among Schwinn distributors were analyzed no differently from those that merely moderated intrabrand competition among retailers. The pivotal factor was the passage of title: All restrictions were held to be per se illegal where title had passed, and all were evaluated and sustained under the rule of reason where it had not. The location restriction at issue here would be subject to the same pattern of analysis under *Schwinn*.

[6] Vertical restrictions reduce intrabrand competition by limiting the number of sellers of a particular product competing for the business of a given group of buyers. Location restrictions have this effect because of practical constraints on the effective marketing area of retail outlets. Although intrabrand competition may be reduced, the ability of retailers to exploit the resulting market may be limited both by the ability of consumers to travel to other franchised locations and, perhaps more importantly, to purchase the competing products of other manufacturers. None of these key variables, however, is affected by the form of the transaction by which a manufacturer conveys his products to the retailers.

[7] Vertical restrictions promote interbrand competition by allowing the manufacturer to achieve certain efficiencies in the distribution of his products. These "redeeming virtues" are implicit in every decision sustaining vertical restrictions under the rule of reason. Economists have identified a number of ways in which manufacturers

[19] Interbrand competition is the competition among the manufacturers of the same generic product television sets in this case and is the primary concern of antitrust law. The extreme example of a deficiency of interbrand competition is monopoly, where there is only one manufacturer. In contrast, intrabrand competition is the competition between the distributors wholesale or retail of the product of a particular manufacturer.

can use such restrictions to compete more effectively against other manufacturers.[23] For example, new manufacturers and manufacturers entering new markets can use the restrictions in order to induce competent and aggressive retailers to make the kind of investment of capital and labor that is often required in the distribution of products unknown to the consumer. Established manufacturers can use them to induce retailers to engage in promotional activities or to provide service and repair facilities necessary to the efficient marketing of their products. Service and repair are vital for many products, such as automobiles and major household appliances. The availability and quality of such services affect a manufacturer's goodwill and the competitiveness of his product. Because of market imperfections such as the so-called "free rider" effect, these services might not be provided by retailers in a purely competitive situation, despite the fact that each retailer's benefit would be greater if all provided the services than if none did.

[8] Economists also have argued that manufacturers have an economic interest in maintaining as much intrabrand competition as is consistent with the efficient distribution of their products. Although the view that the manufacturer's interest necessarily corresponds with that of the public is not universally shared, even the leading critic of vertical restrictions concedes that *Schwinn*'s distinction between sale and nonsale transactions is essentially unrelated to any relevant economic impact. Indeed, to the extent that the form of the transaction is related to interbrand benefits, the Court's distinction is inconsistent with its articulated concern for the ability of smaller firms to compete effectively with larger ones. Capital requirements and administrative expenses may prevent smaller firms from using the exception for nonsale transactions.

[9] We conclude that the distinction drawn in *Schwinn* between sale and nonsale transactions is not sufficient to justify the application of a per se rule in one situation and a rule of reason in the other. The question remains whether the *per se* rule stated in *Schwinn* should be expanded to include non-sale transactions or abandoned in favor of a return to the rule of reason. We have found no persuasive support for expanding the *per se* rule. As noted above, the *Schwinn* Court recognized the undesirability of prohibiting all vertical restrictions of territory and all franchising. And even Continental does not urge us to hold that all such restrictions are *per se* illegal.

[10] We revert to the standard articulated in [earlier cases] for determining whether vertical restrictions must be conclusively presumed to be unreasonable and therefore illegal without elaborate inquiry as to the precise harm they have caused or the business excuse for their use. Such restrictions, in varying forms, are widely used in our free market economy. As indicated above, there is substantial scholarly and judicial authority supporting their economic utility. There is relatively little authority to the contrary. Certainly, there has been no showing in this case, either generally or with respect to Sylvania's agreements, that vertical restrictions have or are likely to have a "pernicious effect on competition" or that they "lack . . . any redeeming virtue." Accordingly, we conclude that the *per se* rule stated in *Schwinn* must be overruled. In so holding we do not foreclose the possibility that particular applications of vertical restrictions might justify *per se* prohibition . . . . But we do make clear that departure from the rule-of-reason standard must be based upon demonstrable economic effect rather than as in *Schwinn* upon formalistic line drawing.

[11] In sum, we conclude that the appropriate decision is to return to the rule of reason that governed vertical restrictions prior to *Schwinn*. When anticompetitive effects are shown to result from particular vertical restrictions they can be adequately policed under the rule of reason, the standard traditionally applied for the majority of anticompetitive practices challenged under s 1 of the Act.

Justice White, concurring in the judgment.

[12] I have . . . substantial misgivings about the approach the majority takes to overruling *Schwinn*. The reason for the distinction in *Schwinn* between sale and nonsale transactions was not, as the majority would have it, the Court's effort to accommodate the perceived intrabrand harm and interbrand benefit of vertical restrictions, the reason

[23] Marketing efficiency is not the only legitimate reason for a manufacturer's desire to exert control over the manner in which his products are sold and serviced. As a result of statutory and common-law developments, society increasingly demands that manufacturers assume direct responsibility for the safety and quality of their products. For example, at the federal level, apart from more specialized requirements, manufacturers of consumer products have safety responsibilities under the Consumer Product Safety Act, and obligations for warranties under the Consumer Product Warranties Act. Similar obligations are imposed by state law. The legitimacy of these concerns has been recognized in cases involving vertical restrictions.

was rather, as Judge Browning argued in dissent below, the notion in many of our cases involving vertical restraints that independent businessmen should have the freedom to dispose of the goods they own as they see fit. Thus the first case cited by the Court in *Schwinn* for the proposition that restraints upon alienation are beyond the power of the manufacturer to impose upon its vendees and are violations of s 1 of the Sherman Act, was this Court's seminal decision holding, a series of resale-price-maintenance agreements per se illegal. Dr. Miles Medical Co. v. John D. Park & Sons Co., 220 U.S. 373, (1911). In *Dr. Miles* the Court stated that a general restraint upon alienation is ordinarily invalid, citing Coke on Littleton, and emphasized that the case involved agreements restricting the freedom of trade on the part of dealers who own what they sell. . . .

[13] This concern for the freedom of the businessman to dispose of his own goods as he sees fit is most probably the explanation for two subsequent cases in which the Court allowed manufacturers to achieve economic results similar to that in *Dr. Miles* where they did not impose restrictions on dealers who had purchased their products [*i.e.*, United States v. Colgate & Co., 250 U.S. 300 (1919) and United States v. General Electric Co., 272 U.S. 476 (1926)].

[14] After summarily rejecting this concern, reflected in our interpretations of the Sherman Act, for the autonomy of independent businessmen, the majority not surprisingly finds no justification for *Schwinn*'s distinction between sale and nonsale transactions because the distinction is essentially unrelated to any relevant economic impact. But while according some weight to the businessman's interest in controlling the terms on which he trades in his own goods may be anathema to those who view the Sherman Act as directed solely to economic efficiency, this principle is without question more deeply embedded in our cases than the notions of "free rider" effects and distributional efficiencies borrowed by the majority from the new economics of vertical relationships. Perhaps the Court is right in partially abandoning this principle and in judging the instant nonprice vertical restraints solely by their "relevant economic impact"; but the precedents which reflect this principle should not be so lightly rejected by the Court. The rationale of *Schwinn* is no doubt difficult to discern from the opinion, and it may be wrong; it is not, however, the aberration the majority makes it out to be here.

GTE Sylvania Inc. v. Continental T.V., Inc.

537 F.2d 980 (9th Cir. 1976)

Judge Browning, dissenting.

[1] Sylvania's conduct toward Continental thwarted an important purpose of the Sherman Act. Legislative history and Supreme Court decisions establish that a principal objective of the Sherman Act was to protect the right of independent business entities to make their own competitive decisions, free of coercion, collusion, or exclusionary practices.

[2] Congress' general purpose in passing the Sherman Act was to limit and restrain accumulated economic power, represented by the trusts, and to restore and preserve a system of free competitive enterprise. The congressional debates reflect a concern not only with the consumer interest in price, quality, and quantity of goods and services, but also with society's interest in the protection of the independent businessman, for reasons of social and political as well as economic policy.[1]

[3] The Supreme Court has implemented the statutory policy of protecting the independence of individual business units in a series of decisions banning resale price maintenance agreements. These cases are particularly relevant here for, like territorial restraints, resale price maintenance is justified by manufacturers as necessary to enable them to control intrabrand competition by independent dealers in the interest of effective interbrand

[1] If the majority's statement that "the legislative intent underlying the Sherman Act had as its goal the promotion of consumer welfare" is meant to exclude other purposes, it is refuted by the legislative history referred to in the authorities cited herein. Even assuming that some contemporary economists might maintain that in a given case consumer interests might be better served by eliminating competition between independent businessmen, [t]here is little evidence that Sherman and the others had any idea of imposing an economist's model of competition on American industry. They did not consult economists of the time; and if they had done so, they would have found little support for any such course. In striking contrast to the views of the Congress, economists of the late 1800's considered "trusts" and other combinations to be a natural evolutionary advance, and monopolies to be both inevitable and potentially beneficial. Considering the level of economic thought prevailing in 1890, it is inconceivable that Congress passed the Sherman Act out of an exclusive preoccupation with the idea that prices should always equal marginal costs.

competition. Indeed, "any argument that can be made on behalf of exclusive territories can also be made on behalf of resale price maintenance."

[4] In the first resale price maintenance decision, Dr. Miles Medical Co. v. John D. Park & Sons Co., 220 U.S. 373 (1911), contracts between a manufacturer and its dealers setting minimum retail prices at which the product could be sold were held illegal in part because they created a restraint upon alienation, which the Court described as restricting the freedom of trade on the part of dealers who own what they sell. The Court concluded that after Dr. Miles sold its product at prices satisfactory to itself, the public is entitled to whatever advantage may be derived from competition in the subsequent traffic. [. . .]

[5] The same theme of protecting the right of independent business entities to compete runs through Supreme Court decisions holding group boycotts illegal per se. . . . .

[6] In many other contexts, the Supreme Court has rested decisions upon the premise that protection of the freedom to compete of separate business entities is an important objective of the Sherman Act. In Silver v. New York Stock Exchange, 373 U.S. 341 (1963), for example, the Court reasoned that the antitrust laws are an appropriate check upon anticompetitive conduct of market exchanges, since the antitrust laws serve, among other things, to protect competitive freedom, i.e., the freedom of individual business units to compete unhindered by the group action of others. A combination between General Motors and some of its dealers to eliminate sales through "discount houses" was held per se illegal . . . because it served to eliminate a class of competitors by terminating business dealings between them and a minority of Chevrolet dealers and to deprive franchised dealers of their freedom to deal through discounters if they so choose. . . . .

[7] From the holdings and rationale of these and other Supreme Court decisions, it seems clear that the protection of individual traders from unnecessary restrictions upon their freedom of action is a significant independent objective of antitrust policy. As a commentator recently put it, "The most important of the social policy objectives found in the Court's antitrust decisions are the concepts of business independence and freedom of business opportunity." In Judge Hand's well-known words [in United States v. Aluminum Co. of America, 148 F.2d 416, 427 (2d Cir. 1945)], Congress was not "actuated by economic motives alone. It is possible, because of its indirect social or moral effect, to prefer a system of small producers, each dependent for his success upon his own skill and character, to one in which the great mass of those engaged must accept the directions of a few. These considerations, which we have suggested as possible purposes of the Act, we think the decisions prove to have been in fact its purposes." [. . .]

[8] Despite the majority's contention that a *per se* rule is appropriate only if the restraint "lacks any redeeming virtue," the Supreme Court's holding in *Schwinn* and *Topco* that a restriction upon the territory in which independent traders may resell is per se illegal did not depend upon a conclusion that this restraint has no affirmative value. On the contrary, the Supreme Court recognized that in some circumstances a territorial restraint may promote competition. The Court held that such a restraint is nonetheless per se illegal when imposed upon independent business entities (1) because such a restraint is "obviously destructive" of competition among independent dealers, and (2) because it is not an appropriate judicial function to strike a public interest balance between the certain loss of competition among independent dealers and a possible gain of competition at some other point in the marketing process. [. . .]

[9] The Supreme Court has held that it is not an appropriate judicial function to weigh the loss of intrabrand competition against an alleged gain in interbrand competition in determining whether the Sherman Act has been violated for two related reasons. The first is that courts are ill-equipped to resolve the complex economic problems involved in deciding in a given case whether elimination of intrabrand competition among dealers through territorial restrictions in fact produced compensating gains in interbrand competition among producers. As the Court said in United States v. Topco Associates, Inc., 405 U.S. 596, 609–10 (1972):

> The fact is that courts are of limited utility in examining difficult economic problems. Our inability to weigh, in any meaningful sense, destruction of competition in one sector of the economy against promotion of competition in another is one important reason we have formulated per se rules.

[10] [. . .] The majority frankly acknowledges "that, as a matter of economic theory, there is a sharp divergence of opinion as to the alleged procompetitive effect of vertical territorial restrictions," but regards this disagreement as a reason for submitting the question of the legality of such restraints to the fact-finding judge or jury. The majority's view of the judicial function is at odds with *Schwinn*, *Topco*, and the traditions and precedent on which they rest. It is also an invitation to a fruitless enterprise.

[11] Sylvania's own expert witness, Professor Lee E. Preston, testified that in the present state of economic analysis it is not possible to determine the effect that changes in marketing practices at one level of a market will have at other levels. [. . .]

[12] A judge or jury should not be expected to determine whether Sylvania's locations practice contributed to Sylvania's success in interbrand competition when Sylvania's expert witness was unable to do so. Because the interbrand effects of Sylvania's locations practice cannot be measured, a decision as to whether the net effect of the practice was procompetitive would be sheer guesswork. Finally, as has been shown, even if a net gain in purely economic terms could be established, such restraints could not be sustained consistent with Schwinn, Topco, and the purpose of the Sherman Act to maintain the competitive freedom of independent business units.

[13] The second reason given by the Supreme Court in *Topco* in support of its holding that courts are unsuitable for the task of deciding whether intrabrand competition among independent dealers should be sacrificed to promote interbrand competition among producers, is that the question is one of public policy properly determined by Congress. The Court said:

> If a decision is to be made to sacrifice competition in one portion of the economy for greater competition in another portion, this too is a decision that must be made by Congress and not by private forces or by the courts. Private forces are too keenly aware of their own interests in making such decisions and courts are ill-equipped and ill-situated for such decisionmaking. To analyze, interpret, and evaluate the myriad of competing interests and the endless data that would surely be brought to bear on such decisions, and to make the delicate judgment on the relative values to society of competitive areas of the economy, the judgment of the elected representatives of the people is required.

[14] A judicial tradition, dating at least from Judge Taft's opinion in *Addyston Pipe* in 1898, bars the courts from weighing conflicting economic predictions to determine the public interest in antitrust litigation. Even when applying the rule of reason, the courts have not inquired whether on some ultimate reckoning of social or economic debits or credits the conduct may be deemed beneficial. A value choice of such magnitude is beyond the ordinary limits of judicial competence.

[15] This tradition is founded, as the Supreme Court said in *Topco*, both upon the inadequacy of the judicial process to deal with such disputes, and upon a conviction that questions of economic policy are for legislative rather than judicial determination. The courts have shown that they can get at the facts of agreement and restrictive intent but cannot find a truly justiciable issue in the choice between rival economic predictions. [. . .]

2. Price Restraints: Resale Price Maintenance

For a long time it was *per se* unlawful for a manufacturer and a retailer of a particular product to agree on the price, or minimum price, at which the product would be sold. This rule against "vertical price fixing" was established by the Supreme Court in the 1911 *Dr. Miles* decision, and lasted almost a century until it was overruled in 2007.[421] Indeed, some early discussions of price-fixing often do not distinguish clearly between "horizontal" and "vertical" price-fixing.[422]

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[421] Congress intervened to exempt certain retail RPM agreements from antitrust scrutiny in the Miller-Tydings Act of 1937 and the McGuire Act of 1952; these efforts were repealed in 1976. *See generally* Note, *Resale Price Maintenance and the McGuire Act*, 27 St. J. L. Rev. 379 (1953); David F. Shores, *Vertical Price-Fixing and the Contract Conundrum: Beyond* Monsanto, 54 Fordham L. Rev. 377, 379–80 (1985).

[422] *See, e.g.*, United States v. Bausch & Lomb Optical Co., 321 U.S. 707, 719–20 (1944) (stating, in a resale price maintenance case: "[T]he retail license provisions binding dealers to sell at locally prevailing prices and only to the public constitute illegal restraints.

In *Dr. Miles*, the Court considered the legality of an agreement between a manufacturer of medicines and the retailers through which they were sold to the public, which established retail prices for the medicines. The Court concluded that "fixing of prices" of this kind was illegal, regardless of the "advantages which the participants expect to derive" from the agreements. Justice Holmes dissented. As you read these extracts, keep an eye out for the freedom / welfare tension we have seen in the history of the law of nonprice intrabrand restraints.

Dr. Miles Medical Co. v. John D. Park & Sons Co.

220 U.S. 373 (1911)

Justice Hughes.

[1] [We now consider] whether the complainant . . . is entitled to maintain the restrictions [on price] by virtue of the fact that they relate to products of its own manufacture.

[2] The basis of the argument appears to be that, as the manufacturer may make and sell, or not, as he chooses, he may affix conditions as to the use of the article or as to the prices at which purchasers may dispose of it. The propriety of the restraint is sought to be derived from the liberty of the producer.

[3] But because a manufacturer is not bound to make or sell, it does not follow in case of sales actually made he may impose upon purchasers every sort of restriction. Thus, a general restraint upon alienation is ordinarily invalid. The right of alienation is one of the essential incidents of a right of general property in movables, and restraints upon alienation have been generally regarded as obnoxious to public policy, which is best subserved by great freedom of traffic in such things as pass from hand to hand. . . .

[4] Nor can the manufacturer by rule and notice, in the absence of contract or statutory right, even though the restriction be known to purchasers, fix prices for future sales. It has been held by this court that no such privilege exists under the copyright statutes, although the owner of the copyright has the sole right to vend copies of the copyrighted production. . . . It will hardly be contended, with respect to such a matter, that the manufacturer of an article of commerce not protected by any statutory grant is in any better case. Whatever right the manufacturer may have to project his control beyond his own sales must depend not upon an inherent power incident to production and original ownership, but upon agreement.

[5] With respect to contracts in restraint of trade, the earlier doctrine of the common law has been substantially modified in adaptation to modern conditions. But the public interest is still the first consideration. To sustain the restraint, it must be found to be reasonable both with respect to the public and to the parties, and that it is limited to what is fairly necessary, in the circumstances of the particular case, for the protection of the covenantee. Otherwise restraints of trade are void as against public policy. [. . .]

[6] The present case is not analogous to that of a sale of good will, or of an interest in a business, or of the grant of a right to use a process of manufacture. The complainant has not parted with any interest in its business or instrumentalities of production. It has conferred no right by virtue of which purchasers of its products may compete with it. It retains complete control over the business in which it is engaged, manufacturing what it pleases and fixing such prices for its own sales as it may desire. Nor are we dealing with a single transaction, conceivably unrelated to the public interest. The agreements are designed to maintain prices after the complainant has parted with the title to the articles, and to prevent competition among those who trade in them.

[7] The bill asserts the importance of a standard retail price, and alleges generally that confusion and damage have resulted from sales at less than the prices fixed. But the advantage of established retail prices primarily concerns the dealers. The enlarged profits which would result from adherence to the established rates would go to them, and not to the complainant. It is through the inability of the favored dealers to realize these profits, on account of the described competition, that the complainant works out its alleged injury. If there be an advantage to the manufacturer in the maintenance of fixed retail prices, the question remains whether it is one which he is

Our former decisions compel this conclusion. Price fixing, reasonable or unreasonable, is unlawful per se.") (internal quotation marks omitted); *see also* John C. Peppin, *Price-Fixing Agreements under the Sherman Anti-Trust Law*, 28 Calif. L. Rev. 297, 300 (1940) (noting that in light of recent case law a resale price maintenance agreement could be treated identically to a horizontal cartel).

entitled to secure by agreements restricting the freedom of trade on the part of dealers who own what they sell. As to this, the complainant can fare no better with its plan of identical contracts than could the dealers themselves if they formed a combination and endeavored to establish the same restrictions, and thus to achieve the same result, by agreement with each other. If the immediate advantage they would thus obtain would not be sufficient to sustain such a direct agreement, the asserted ulterior benefit to the complainant cannot be regarded as sufficient to support its system.

[8] But agreements or combinations between dealers, having for their sole purpose the destruction of competition and the fixing of prices, are injurious to the public interest and void. They are not saved by the advantages which the participants expect to derive from the enhanced price to the consumer.

[9] The complainant's plan falls within the principle which condemns contracts of this class. It, in effect, creates a combination for the prohibited purposes. No distinction can properly be made by reason of the particular character of the commodity in question. It is not entitled to special privilege or immunity. It is an article of commerce, and the rules concerning the freedom of trade must be held to apply to it. Nor does the fact that the margin of freedom is reduced by the control of production make the protection of what remains, in such a case, a negligible matter. And where commodities have passed into the channels of trade and are owned by dealers, the validity of agreements to prevent competition and to maintain prices is not to be determined by the circumstance whether they were produced by several manufacturers or by one, or whether they were previously owned by one or by many. The complainant having sold its product at prices satisfactory to itself, the public is entitled to whatever advantage may be derived from competition in the subsequent traffic.

Justice Holmes, dissenting.

[10] [. . .] The sale to the retailers is made by the plaintiff, and the only question is whether the law forbids a purchaser to contract with his vendor that he will not sell below a certain price. This is the important question in this case. I suppose that in the case of a single object, such as a painting or a statute, the right of the artist to make such a stipulation hardly would be denied. In other words, I suppose that the reason why the contract is held bad is that it is part of a scheme embracing other similar contracts, each of which applies to a number of similar things, with the object of fixing a general market price. This reason seems to me inadequate in the case before the court. In the first place, by a slight change in the form of the contract the plaintiff can accomplish the result in a way that would be beyond successful attack. if it should make the retail dealers also agents in law as well as in name, and retain the title until the goods left their hands, I cannot conceive that even the present enthusiasm for regulating the prices to be charged by other people would deny that the owner was acting within his rights. It seems to me that this consideration by itself ought to give us pause.

[11] But I go farther. There is no statute covering the case; there is no body of precedent that, by ineluctable logic, requires the conclusion to which the court has come. The conclusion is reached by extending a certain conception of public policy to a new sphere. On such matters we are in perilous country. I think that at least it is safe to say that the most enlightened judicial policy is to let people manage their own business in their own way, unless the ground for interference is very clear. What, then, is the ground upon which we interfere in the present case? Of course, it is not the interest of the producer. No one, I judge, cares for that. It hardly can be the interest of subordinate vendors, as there seems to be no particular reason for preferring them to the originator and first vendor of the product. Perhaps it may be assumed to be the interest of the consumers and the public. On that point I confess that I am in a minority as to larger issues than are concerned here. I think that we greatly exaggerate the value and importance to the public of competition in the production or distribution of an article (here it is only distribution) as fixing a fair price. What really fixes that is the competition of conflicting desires. We, none of us, can have as much as we want of all the things that we want. Therefore, we have to choose. As soon as the price of something that we want goes above the point at which we are willing to give up other things to have that, we cease to buy it and buy something else. Of course, I am speaking of things that we can get along without. There may be necessaries that sooner or later must be dealt with like short rations in a shipwreck, but they are not Dr. Miles's medicines. With regard to things like the latter, it seems to me that the point of most profitable returns marks the equilibrium of social desires, and determines the fair price in the only sense in which I can find meaning in those words. The Dr. Miles Medical Company knows better than we do what will enable it to do the best business. We must assume its retail price to be reasonable, for it is so alleged and the case is here on demurrer; so I see nothing

to warrant my assuming that the public will not be served best by the company being allowed to carry out its plan. I cannot believe that in the long run the public will profit by this court permitting knaves to cut reasonable prices for some ulterior purpose of their own, and thus to impair, if not to destroy, the production and sale of articles which it is assumed to be desirable that the public should be able to get.

* * *

The *per se* rule established in *Dr. Miles* against the fixing of a minimum resale price was criticized as "judicial legislation" by no less an authority than Louis Brandeis.

Louis D. Brandeis, Competition That Kills

Harper's Weekly (Nov. 15, 1913)

When a court decides a case upon grounds of public policy, the judges become, in effect, legislators. The question then involved is no longer one for lawyers only. It seems fitting, therefore, to inquire whether this judicial legislation is sound—whether the common trade practice of maintaining the price of trade-marked articles has been justly condemned. And when making that inquiry we may well bear in mind this admonition of Sir George Jessel, a very wise English judge:

> If there is one thing which more than any other public policy requires, it is that men of full age and competent understanding shall have the utmost liberty of contracting, and that their contracts, when entered into freely and voluntarily, shall be held sacred, and shall be enforced by courts of justice. Therefore, you have this paramount public policy to consider, that you are not lightly to interfere with this freedom of contract.

The Supreme Court says that a contract by which a producer binds a retailer to maintain the established selling price of his trade-marked product is void; because it prevents competition between retailers of the article and restrains trade.

Such a contract does, in a way, limit competition; but no man is bound to compete with himself. And when the same trade-marked article is sold in the same market by one dealer at a less price than by another, the producer, in effect, competes with himself. To avoid such competition, the producer of a trade-marked article often sells it to but a single dealer in a city or town; or he establishes an exclusive sales agency. No one has questioned the legal right of an independent producer to create such exclusive outlets for his product. But if exclusive selling agencies are legal, why should the individual manufacturer of a trade-marked article be prevented from establishing a marketing system under which his several agencies for distribution will sell at the same price? There is no difference, in substance, between an agent who retails the article and a dealer who retails it.

For many business concerns the policy of maintaining a standard price for a standard article is simple. The village baker readily maintained the quality and price of his product, by sale and delivery over his own counter. The great Standard Oil monopoly maintains quality and price (when it desires so to do) by selling throughout the world to the retailer or the consumer from its own tank-wagons. But for most producers the jobber and the retailer are the necessary means of distribution—as necessary as the railroad, the express or the parcel post. The Standard Oil Company can, without entering into contracts with dealers, maintain the price through its dominant power. Shall the law discriminate against the lesser concerns which have not that power, and deny them the legal right to contract with dealers to accomplish a like result? For in order to insure to the small producer the ability to maintain the price of his product, the law must afford him contract protection, when he deals through the middleman.

But the Supreme Court says that a contract which prevents a dealer of trade-marked articles from cutting the established selling price, restrains trade. In a sense every contract restrains trade; for after one has entered into a contract, he is not as free in trading as he was before he bound himself. But the right to bind one's self is essential to trade development. And it is not every contract in restraint of trade, but only contracts unreasonably in restraint of trade, which are invalid. Whether a contract does unreasonably restrain trade is not to be determined by abstract reasoning. Facts only can be safely relied upon to teach us whether a trade practice is consistent with the general welfare. And abundant experience establishes that the one-price system, which marks so important an advance in the ethics of trade, has also greatly increased the efficiency of merchandising, not only for the producer, but for the dealer and the consumer as well.

* * *

The criticism of antitrust's tough line on RPM resulted in legislative efforts to soften the rigor of the rule. The Miller-Tydings Act of 1937 and the McGuire Act of 1952 allowed state governments to authorize resale price maintenance, enduring until the Consumer Goods Pricing Act of 1975.[423]

Despite the criticism, the *per se* rule endured for a long time. In *Albrecht* in 1968—which imposed liability on a newspaper publisher that set a maximum price for its newspaper carriers to avoid them overcharging customers—the Court's skepticism of price restraints reached an all-time-high, with the holding that the *per se* rule against RPM flatly forbids fixing even a *maximum* resale price. From that point on, the *per se* rule against RPM came under steadily increasing pressure. Perhaps appropriately enough, the retreat started with maximum RPM.

The Law of Maximum RPM

Albrecht v. Herald Co., 390 U.S. 145 (1968); State Oil Co. v. Khan, 522 U.S. 3 (1997)

In 1968, the Court held in *Albrecht* that it was *per se* illegal for an upstream firm to agree a *maximum* resale price with its distributors. In that case, a newspaper publisher, Herald, had set a maximum price for its newspapers, to prevent its carriers overcharging customers. One carrier, Albrecht, violated the policy, and so Herald engaged an alternative carrier that was willing to comply. Albrecht sued under Section 1, and won in the Supreme Court.

The Court, in an opinion by Justice White, was unmoved by the argument that setting *maximum* prices was unlikely to cause competitive harm: "Maximum prices may be fixed too low for the dealer to furnish services essential to the value which goods have for the consumer or to furnish services and conveniences which consumers desire and for which they are willing to pay. Maximum price fixing may channel distribution through a few large or specifically advantaged dealers who otherwise would be subject to significant nonprice competition. Moreover, if the actual price charged under a maximum price scheme is nearly always the fixed maximum price, which is increasingly likely as the maximum price approaches the actual cost of the dealer, the scheme tends to acquire all the attributes of an arrangement fixing minimum prices." *Per se* illegality was the result.

Dissenting in *Albrecht*, Justice Harlan argued that a manufacturer's choice of distribution method was essentially a unilateral policy decision—there was no meaningful "conspiracy" between Herald and the new carrier—and that Herald had every incentive to set rules that maximized distribution of its newspapers and suited its customers.

But the rule against maximum RPM did not last. In *Atlantic Richfield* in 1990, the Court rejected an antitrust suit brought by a competitor on the theory that maximum RPM had led to a price that was unfairly low, and in doing so it implicitly recognized that low prices were a procompetitive benefit of the maximum RPM policies in that case.[424] And in 1997, in *Khan*, the *per se* ban on maximum RPM was explicitly overruled.

Justice O'Connor's opinion for the Court in *Khan* closely echoes the themes of *GTE Sylvania* 20 years before, and particularly *Sylvania*'s turn from dealer freedom to consumer welfare. Adjudicating a challenge to an RPM policy imposed by a gasoline supplier on gas stations, the Court emphasized the primacy of consumers and competition: "Low prices . . . benefit consumers regardless of how those prices are set, and so long as they are above predatory levels, they do not threaten competition." The older rule against maximum RPM, set out in *Albrecht*, "was

[423] For contemporary perspectives, *see*, *e.g.*, Note, *Resale Price Maintenance: The Miller-Tydings Enabling Act*, 51 Harv. L. Rev. 336 (1937); Note, *Resale Price Maintenance and the McGuire Act*, 27 St. J. L. Rev. 379 (1953).

[424] Atlantic Richfield Co. v. USA Petroleum Co., 495 U.S. 328, 345–46 (1990) ("A competitor is not injured by the *anticompetitive* effects of vertical, maximum price-fixing . . . and does not have any incentive to vindicate the legitimate interests of a rival's dealer. A competitor will not bring suit to protect the dealer against a maximum price that is set too low, inasmuch as the competitor would *benefit* from such a situation. Instead, a competitor will be motivated to bring suit only when the vertical restraint promotes interbrand competition between the competitor and the dealer subject to the restraint. In short, a competitor will be injured and hence motivated to sue only when a vertical, maximum-price-fixing arrangement has a *procompetitive* impact on the market. Therefore, providing the competitor a cause of action would not protect the rights of dealers and consumers under the antitrust laws.") (emphasis in original).

grounded in the fear that maximum price fixing by suppliers could interfere with dealer freedom." But that concern would no longer govern. "[A]lthough vertical maximum price fixing might limit the viability of inefficient dealers, that consequence is not necessarily harmful to competition and consumers." The *Khan* Court did acknowledge the risk that maximum RPM could be used as a mask for minimum RPM (which was to remain *per se* illegal for another decade): but that concern could be examined under the rubric of the rule of reason. The upshot: "We conclude that *Albrecht* should be overruled."

Finally, the *per se* rule against minimum price fixing gave way also, in the Court's 2007 *Leegin* decision which established that all vertical distribution restraints, nonprice and price alike, should be analyzed under the rule of reason. Leegin—a leather-goods manufacturer that had operated a minimum RPM policy—found *amicus* support from the Justice Department and Federal Trade Commission,[425] and prevailed before the Supreme Court, resulting in the end of *per se* treatment of vertical restraints.

Leegin Creative Leather Products, Inc. v. PSKS, Inc.

551 U.S. 877 (2007)

Justice Kennedy.

[1] Petitioner, Leegin Creative Leather Products, Inc. (Leegin), designs, manufactures, and distributes leather goods and accessories. In 1991, Leegin began to sell belts under the brand name "Brighton." The Brighton brand has now expanded into a variety of women's fashion accessories. It is sold across the United States in over 5,000 retail establishments, for the most part independent, small boutiques and specialty stores. Leegin's president, Jerry Kohl, also has an interest in about 70 stores that sell Brighton products. Leegin asserts that, at least for its products, small retailers treat customers better, provide customers more services, and make their shopping experience more satisfactory than do larger, often impersonal retailers. . . . .

[2] Respondent, PSKS, Inc. (PSKS), operates Kay's Kloset, a women's apparel store in Lewisville, Texas. Kay's Kloset buys from about 75 different manufacturers and at one time sold the Brighton brand. It first started purchasing Brighton goods from Leegin in 1995. Once it began selling the brand, the store promoted Brighton. . . . .

[3] In 1997, Leegin instituted the "Brighton Retail Pricing and Promotion Policy." Following the policy, Leegin refused to sell to retailers that discounted Brighton goods below suggested prices. The policy contained an exception for products not selling well that the retailer did not plan on reordering. In the letter to retailers establishing the policy, Leegin stated:

> In this age of mega stores like Macy's, Bloomingdales, May Co. and others, consumers are perplexed by promises of product quality and support of product which we believe is lacking in these large stores. Consumers are further confused by the ever popular sale, sale, sale, etc.
>
> We, at Leegin, choose to break away from the pack by selling [at] specialty stores; specialty stores that can offer the customer great quality merchandise, superb service, and support the Brighton product 365 days a year on a consistent basis.
>
> We realize that half the equation is Leegin producing great Brighton product and the other half is you, our retailer, creating great looking stores selling our products in a quality manner.

[4] Leegin adopted the policy to give its retailers sufficient margins to provide customers the service central to its distribution strategy. It also expressed concern that discounting harmed Brighton's brand image and reputation. [. . .]

[5] In December 2002, Leegin discovered Kay's Kloset had been marking down Brighton's entire line by 20 percent. Kay's Kloset contended it placed Brighton products on sale to compete with nearby retailers who also

[425] Brief for the United States as Amicus Curiae Supporting Petitioner, Leegin Creative Leather Products, Inc. v. PSKS, Inc., Case No. 06-480 (filed Jan. 22, 2007), 6 ("*Dr. Miles* should be overruled, and . . . RPM should be evaluated under the same rule-of-reason standard that applies to other vertical agreements.").

were undercutting Leegin's suggested prices. Leegin, nonetheless, requested that Kay's Kloset cease discounting. Its request refused, Leegin stopped selling to the store. The loss of the Brighton brand had a considerable negative impact on the store's revenue from sales.

[6] PSKS sued Leegin in the United States District Court for the Eastern District of Texas. It alleged, among other claims, that Leegin had violated the antitrust laws by entering into agreements with retailers to charge only those prices fixed by Leegin. [. . .]

[7] Though each side of the debate can find sources to support its position, it suffices to say here that economics literature is replete with procompetitive justifications for a manufacturer's use of resale price maintenance. *See*, *e.g.*, Brief for Economists as Amici Curiae 16 ("In the theoretical literature, it is essentially undisputed that minimum [resale price maintenance] can have procompetitive effects and that under a variety of market conditions it is unlikely to have anticompetitive effects"); Brief for United States as Amicus Curiae 9 ("[T]here is a widespread consensus that permitting a manufacturer to control the price at which its goods are sold may promote interbrand competition and consumer welfare in a variety of ways"); ABA Section of Antitrust Law, ANTITRUST LAW AND ECONOMICS OF PRODUCT DISTRIBUTION 76 (2006) ("[T]he bulk of the economic literature on [resale price maintenance] suggests that [it] is more likely to be used to enhance efficiency than for anticompetitive purposes"). Even those more skeptical of resale price maintenance acknowledge it can have procompetitive effects.

[8] The few recent studies documenting the competitive effects of resale price maintenance also cast doubt on the conclusion that the practice meets the criteria for a *per se* rule.

[9] The justifications for vertical price restraints are similar to those for other vertical restraints. Minimum resale price maintenance can stimulate interbrand competition—the competition among manufacturers selling different brands of the same type of product—by reducing intrabrand competition—the competition among retailers selling the same brand. The promotion of interbrand competition is important because the primary purpose of the antitrust laws is to protect this type of competition. A single manufacturer's use of vertical price restraints tends to eliminate intrabrand price competition; this in turn encourages retailers to invest in tangible or intangible services or promotional efforts that aid the manufacturer's position as against rival manufacturers. Resale price maintenance also has the potential to give consumers more options so that they can choose among low-price, low-service brands; high-price, high-service brands; and brands that fall in between.

[10] Absent vertical price restraints, the retail services that enhance interbrand competition might be underprovided. This is because discounting retailers can free ride on retailers who furnish services and then capture some of the increased demand those services generate. Consumers might learn, for example, about the benefits of a manufacturer's product from a retailer that invests in fine showrooms, offers product demonstrations, or hires and trains knowledgeable employees. Or consumers might decide to buy the product because they see it in a retail establishment that has a reputation for selling high-quality merchandise. If the consumer can then buy the product from a retailer that discounts because it has not spent capital providing services or developing a quality reputation, the high-service retailer will lose sales to the discounter, forcing it to cut back its services to a level lower than consumers would otherwise prefer. Minimum resale price maintenance alleviates the problem because it prevents the discounter from undercutting the service provider. With price competition decreased, the manufacturer's retailers compete among themselves over services.

[11] Resale price maintenance, in addition, can increase interbrand competition by facilitating market entry for new firms and brands. New manufacturers and manufacturers entering new markets can use the restrictions in order to induce competent and aggressive retailers to make the kind of investment of capital and labor that is often required in the distribution of products unknown to the consumer. New products and new brands are essential to a dynamic economy, and if markets can be penetrated by using resale price maintenance there is a procompetitive effect.

[12] Resale price maintenance can also increase interbrand competition by encouraging retailer services that would not be provided even absent free riding. It may be difficult and inefficient for a manufacturer to make and enforce a contract with a retailer specifying the different services the retailer must perform. Offering the retailer a guaranteed margin and threatening termination if it does not live up to expectations may be the most efficient way

to expand the manufacturer's market share by inducing the retailer's performance and allowing it to use its own initiative and experience in providing valuable services. [. . .]

[13] While vertical agreements setting minimum resale prices can have procompetitive justifications, they may have anticompetitive effects in other cases; and unlawful price fixing, designed solely to obtain monopoly profits, is an ever–present temptation. Resale price maintenance may, for example, facilitate a manufacturer cartel. An unlawful cartel will seek to discover if some manufacturers are undercutting the cartel's fixed prices. Resale price maintenance could assist the cartel in identifying price-cutting manufacturers who benefit from the lower prices they offer. Resale price maintenance, furthermore, could discourage a manufacturer from cutting prices to retailers with the concomitant benefit of cheaper prices to consumers.

[14] Vertical price restraints also might be used to organize cartels at the retailer level. A group of retailers might collude to fix prices to consumers and then compel a manufacturer to aid the unlawful arrangement with resale price maintenance. In that instance the manufacturer does not establish the practice to stimulate services or to promote its brand but to give inefficient retailers higher profits. Retailers with better distribution systems and lower cost structures would be prevented from charging lower prices by the agreement. Historical examples suggest this possibility is a legitimate concern.

[15] A horizontal cartel among competing manufacturers or competing retailers that decreases output or reduces competition in order to increase price is, and ought to be, per se unlawful. To the extent a vertical agreement setting minimum resale prices is entered upon to facilitate either type of cartel, it, too, would need to be held unlawful under the rule of reason. This type of agreement may also be useful evidence for a plaintiff attempting to prove the existence of a horizontal cartel.

[16] Resale price maintenance, furthermore, can be abused by a powerful manufacturer or retailer. A dominant retailer, for example, might request resale price maintenance to forestall innovation in distribution that decreases costs. A manufacturer might consider it has little choice but to accommodate the retailer's demands for vertical price restraints if the manufacturer believes it needs access to the retailer's distribution network. A manufacturer with market power, by comparison, might use resale price maintenance to give retailers an incentive not to sell the products of smaller rivals or new entrants. As should be evident, the potential anticompetitive consequences of vertical price restraints must not be ignored or underestimated. [. . .]

[17] Notwithstanding the risks of unlawful conduct, 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. Vertical agreements establishing minimum resale prices can have either procompetitive or anticompetitive effects, depending upon the circumstances in which they are formed. And although the empirical evidence on the topic is limited, it does not suggest efficient uses of the agreements are infrequent or hypothetical. As the rule would proscribe a significant amount of procompetitive conduct, these agreements appear ill suited for per se condemnation.

[18] Respondent contends, nonetheless, that vertical price restraints should be per se unlawful because of the administrative convenience of *per se* rules. That argument suggests *per se* illegality is the rule rather than the exception. This misinterprets our antitrust law. *Per se* rules may decrease administrative costs, but that is only part of the equation. Those rules can be counterproductive. They can increase the total cost of the antitrust system by prohibiting procompetitive conduct the antitrust laws should encourage. They also may increase litigation costs by promoting frivolous suits against legitimate practices. The Court has thus explained that administrative advantages are not sufficient in themselves to justify the creation of *per se* rules, and has relegated their use to restraints that are manifestly anticompetitive. Were the Court now to conclude that vertical price restraints should be *per se* illegal based on administrative costs, we would undermine, if not overrule, the traditional demanding standards for adopting per se rules. Any possible reduction in administrative costs cannot alone justify the Dr. Miles rule.

[19] Respondent also argues the *per se* rule is justified because a vertical price restraint can lead to higher prices for the manufacturer's goods. *See also* [T. Overstreet, RESALE PRICE MAINTENANCE: ECONOMIC THEORIES AND EMPIRICAL EVIDENCE (1983)] 160 (noting that "price surveys indicate that [resale price maintenance] in most

cases increased the prices of products sold"). Respondent is mistaken in relying on pricing effects absent a further showing of anticompetitive conduct. *Cf. id.*, at 106 (explaining that price surveys "do not necessarily tell us anything conclusive about the welfare effects of [resale price maintenance] because the results are generally consistent with both procompetitive and anticompetitive theories"). For, as has been indicated already, the antitrust laws are designed primarily to protect interbrand competition, from which lower prices can later result. The Court, moreover, has evaluated other vertical restraints under the rule of reason even though prices can be increased in the course of promoting procompetitive effects. And resale price maintenance may reduce prices if manufacturers have resorted to costlier alternatives of controlling resale prices that are not per se unlawful.

[20] Respondent's argument, furthermore, overlooks that, in general, the interests of manufacturers and consumers are aligned with respect to retailer profit margins. The difference between the price a manufacturer charges retailers and the price retailers charge consumers represents part of the manufacturer's cost of distribution, which, like any other cost, the manufacturer usually desires to minimize. A manufacturer has no incentive to overcompensate retailers with unjustified margins. The retailers, not the manufacturer, gain from higher retail prices. The manufacturer often loses; interbrand competition reduces its competitiveness and market share because consumers will substitute a different brand of the same product. As a general matter, therefore, a single manufacturer will desire to set minimum resale prices only if the increase in demand resulting from enhanced service will more than offset a negative impact on demand of a higher retail price.

[21] The implications of respondent's position are far reaching. Many decisions a manufacturer makes and carries out through concerted action can lead to higher prices. A manufacturer might, for example, contract with different suppliers to obtain better inputs that improve product quality. Or it might hire an advertising agency to promote awareness of its goods. Yet no one would think these actions violate the Sherman Act because they lead to higher prices. The antitrust laws do not require manufacturers to produce generic goods that consumers do not know about or want. The manufacturer strives to improve its product quality or to promote its brand because it believes this conduct will lead to increased demand despite higher prices. The same can hold true for resale price maintenance.

[22] Resale price maintenance, it is true, does have economic dangers. If the rule of reason were to apply to vertical price restraints, courts would have to be diligent in eliminating their anticompetitive uses from the market. This is a realistic objective, and certain factors are relevant to the inquiry. For example, the number of manufacturers that make use of the practice in a given industry can provide important instruction. When only a few manufacturers lacking market power adopt the practice, there is little likelihood it is facilitating a manufacturer cartel, for a cartel then can be undercut by rival manufacturers. Likewise, a retailer cartel is unlikely when only a single manufacturer in a competitive market uses resale price maintenance. Interbrand competition would divert consumers to lower priced substitutes and eliminate any gains to retailers from their price-fixing agreement over a single brand. Resale price maintenance should be subject to more careful scrutiny, by contrast, if many competing manufacturers adopt the practice.

[23] The source of the restraint may also be an important consideration. If there is evidence retailers were the impetus for a vertical price restraint, there is a greater likelihood that the restraint facilitates a retailer cartel or supports a dominant, inefficient retailer. If, by contrast, a manufacturer adopted the policy independent of retailer pressure, the restraint is less likely to promote anticompetitive conduct. A manufacturer also has an incentive to protest inefficient retailer-induced price restraints because they can harm its competitive position. [. . .]

[24] The rule of reason is designed and used to eliminate anticompetitive transactions from the market. This standard principle applies to vertical price restraints. A party alleging injury from a vertical agreement setting minimum resale prices will have, as a general matter, the information and resources available to show the existence of the agreement and its scope of operation. As courts gain experience considering the effects of these restraints by applying the rule of reason over the course of decisions, they can establish the litigation structure to ensure the rule operates to eliminate anticompetitive restraints from the market and to provide more guidance to businesses. Courts can, for example, devise rules over time for offering proof, or even presumptions where justified, to make the rule of reason a fair and efficient way to prohibit anticompetitive restraints and to promote procompetitive ones. [. . .]

[25] For these reasons the Court's decision in *Dr. Miles Medical Co. v. John D. Park & Sons Co.*, 220 U.S. 373 (1911), is now overruled. Vertical price restraints are to be judged according to the rule of reason.

Justice Breyer, dissenting, joined by Justices Stevens, Souter, and Ginsburg.

[26] On the one hand, agreements setting minimum resale prices may have serious anticompetitive consequences. In respect to dealers: Resale price maintenance agreements, rather like horizontal price agreements, can diminish or eliminate price competition among dealers of a single brand or (if practiced generally by manufacturers) among multibrand dealers. In doing so, they can prevent dealers from offering customers the lower prices that many customers prefer; they can prevent dealers from responding to changes in demand, say, falling demand, by cutting prices; they can encourage dealers to substitute service, for price, competition, thereby threatening wastefully to attract too many resources into that portion of the industry; they can inhibit expansion by more efficient dealers whose lower prices might otherwise attract more customers, stifling the development of new, more efficient modes of retailing; and so forth.

[27] In respect to producers: Resale price maintenance agreements can help to reinforce the competition-inhibiting behavior of firms in concentrated industries. In such industries firms may tacitly collude, i.e., observe each other's pricing behavior, each understanding that price cutting by one firm is likely to trigger price competition by all. Where that is so, resale price maintenance can make it easier for each producer to identify (by observing retail markets) when a competitor has begun to cut prices. And a producer who cuts wholesale prices without lowering the minimum resale price will stand to gain little, if anything, in increased profits, because the dealer will be unable to stimulate increased consumer demand by passing along the producer's price cut to consumers. In either case, resale price maintenance agreements will tend to prevent price competition from "breaking out"; and they will thereby tend to stabilize producer prices. [. . .]

[28] On the other hand, those favoring resale price maintenance have long argued that resale price maintenance agreements can provide important consumer benefits. The majority lists two: First, such agreements can facilitate new entry. For example, a newly entering producer wishing to build a product name might be able to convince dealers to help it do so—if, but only if, the producer can assure those dealers that they will later recoup their investment. Without resale price maintenance, late-entering dealers might take advantage of the earlier investment and, through price competition, drive prices down to the point where the early dealers cannot recover what they spent. By assuring the initial dealers that such later price competition will not occur, resale price maintenance can encourage them to carry the new product, thereby helping the new producer succeed. The result might be increased competition at the producer level, i.e., greater inter-brand competition, that brings with it net consumer benefits.

[29] Second, without resale price maintenance a producer might find its efforts to sell a product undermined by what resale price maintenance advocates call "free riding." . . . .

[30] The upshot is, as many economists suggest, sometimes resale price maintenance can prove harmful; sometimes it can bring benefits. But before concluding that courts should consequently apply a rule of reason, I would ask such questions as, how often are harms or benefits likely to occur? How easy is it to separate the beneficial sheep from the antitrust goats?

[31] Economic discussion, such as the studies the Court relies upon, can help provide answers to these questions, and in doing so, economics can, and should, inform antitrust law. But antitrust law cannot, and should not, precisely replicate economists' (sometimes conflicting) views. That is because law, unlike economics, is an administrative system the effects of which depend upon the content of rules and precedents only as they are applied by judges and juries in courts and by lawyers advising their clients. And that fact means that courts will often bring their own administrative judgment to bear, sometimes applying rules of per se unlawfulness to business practices even when those practices sometimes produce benefits. [. . .]

[32] How easily can courts identify instances in which the benefits are likely to outweigh potential harms? My own answer is, not very easily. For one thing, it is often difficult to identify who—producer or dealer—is the moving force behind any given resale price maintenance agreement. Suppose, for example, several large multibrand retailers all sell resale-price-maintained products. Suppose further that small producers set retail prices because

they fear that, otherwise, the large retailers will favor (say, by allocating better shelf space) the goods of other producers who practice resale price maintenance. Who "initiated" this practice, the retailers hoping for considerable insulation from retail competition, or the producers, who simply seek to deal best with the circumstances they find? For another thing, as I just said, it is difficult to determine just when, and where, the "free riding" problem is serious enough to warrant legal protection.

[33] I recognize that scholars have sought to develop checklists and sets of questions that will help courts separate instances where anticompetitive harms are more likely from instances where only benefits are likely to be found. But applying these criteria in court is often easier said than done. The Court's invitation to consider the existence of "market power," for example, invites lengthy time-consuming argument among competing experts, as they seek to apply abstract, highly technical, criteria to often ill-defined markets. And resale price maintenance cases, unlike a major merger or monopoly case, are likely to prove numerous and involve only private parties. One cannot fairly expect judges and juries in such cases to apply complex economic criteria without making a considerable number of mistakes, which themselves may impose serious costs.

[34] Are there special advantages to a bright-line rule? Without such a rule, it is often unfair, and consequently impractical, for enforcement officials to bring criminal proceedings. And since enforcement resources are limited, that loss may tempt some producers or dealers to enter into agreements that are, on balance, anticompetitive.

[35] Given the uncertainties that surround key items in the overall balance sheet, particularly in respect to the "administrative" questions, I can concede to the majority that the problem is difficult. And, if forced to decide now, at most I might agree that the per se rule should be slightly modified to allow an exception for the more easily identifiable and temporary condition of new entry. But I am not now forced to decide this question. The question before us is not what should be the rule, starting from scratch. We here must decide whether to change a clear and simple price-related antitrust rule that the courts have applied for nearly a century. [. . .]

[36] . . . I do not believe that the majority has shown new or changed conditions sufficient to warrant overruling a decision of such long standing [as *Dr. Miles*]. All ordinary stare decisis considerations indicate the contrary. For these reasons, with respect, I dissent.

* * *

Leegin—and the correct judicial and economic treatment of resale price maintenance—continues to be a subject of lively debate.[426] (Note that RPM continues to be *per se* illegal under certain state laws.[427]) In principle, today, at least three competitive concerns may be on the cards in RPM cases. First is the concern that the RPM policy is really a vehicle for a dealer cartel, with the manufacturer acting as a cartel enforcer. Second is the concern that parallel RPM policies might be reinforcing a cartel, or perhaps even tacit collusion, among manufacturers. This is because the RPM commitment discourages "cheating" on the cartel: if a manufacturer discounts from the cartel price, its retailer cannot pass on that discount as a lower retail price in order to drive increased sales. Third is the concern that a powerful retailer might demand the RPM policy in order to cut off its low-pricing rivals and thus increase its own retail-level market power.

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[426] *See*, *e.g.*, William S. Comanor & David Salant, *Resale Price Maintenance Post* Leegin: *A Model of RPM Incentives*, 50 Rev. Ind. Org. 169 (2017); Gregory T. Gundlach, *Resale Price Maintenance: A Review and Call for Research*, American Antitrust Institute Working Paper (Apr. 17, 2014); Gregory T. Gundlach, *Overview and contents of the special issue: Antitrust analysis of resale price maintenance after* Leegin, 55 Antitrust Bull. 1 (2010); Richard M. Brunell, *Overruling* Dr. Miles*: The Supreme Trade Commission in Action*, 52 Antitrust Bull. 475 (2007).

[427] *See*, *e.g.*, Alsheikh v. Superior Court, No. B249822, 2013 WL 5530508, at *3 (Cal. App. 2 Dist. Oct. 7, 2013): MD. CODE ANN., COM. LAW § 11-204(b) (defining any "contract, combination, or conspiracy that establishes a minimum price below which a retailer, wholesaler, or distributor may not sell a commodity or service" to be an unreasonable restraint of trade or commerce).

NOTES

1) What is a "brand" in the sense used in *Sylvania* and *Leegin*, and why is competition between, rather than within, brands the primary concern of antitrust law? What alternatives to this approach are plausible?[428] (And can intrabrand restraints ever have interbrand effects?[429])
2) What treatment of intrabrand competition is implied by the cases above: is it relevant but secondary, or completely irrelevant? What factors should lead a court to place greater importance on intrabrand competition in a particular case?
3) "*GTE Sylvania*, read with *Topco* and *Sealy*, implies that if retail markets are divided by a manufacturer, it's practically per se legal; but if the same thing is done by retailers, it's per se illegal." Do you agree?
4) What is most persuasive in Judge Browning's Ninth Circuit dissent in *Sylvania*? What is least persuasive?
5) The shift from *Schwinn* to *GTE Sylvania* seems to reflect the view that antitrust law should treat agreements between manufacturers and resellers, and agreements between manufacturers and their sales agents, identically. Are there circumstances under which you think this difference should affect antitrust analysis: that is, are there things that manufacturers should be able to agree with trading partners in one of these categories but not the other?
6) Some suppliers do not distribute their products or services through third parties at all: instead, they do it themselves, through "closed" vertically integrated distribution systems. One reason that they might choose to do this is if antitrust law would create a liability risk if they tried to implement their desired distribution method through restrictive contracts with trading partners. Should antitrust law favor or disfavor the use of closed systems, rather than the kind of open systems at issue in *Schwinn* and *GTE Sylvania*? Would your answer change if we were talking about digital ecosystems rather than traditional consumer goods?[430]
7) Should it be *per se* legal for a manufacturer to establish single exclusive authorized distributors, selling at specified prices, in each geographic area? If so, how can *less* restrictive systems plausibly be unlawful? If not, couldn't the manufacturer simply accomplish the same thing by making itself the only distributor of its products?
8) To the extent that manufacturers (or courts) may be worried about "free riding" by some retailers on the efforts of others, would it make a difference if retailers could:
    a. charge consumers directly for the services?
    b. be bound by contract with a manufacturer to provide such services in exchange for specific compensation?
9) Resale price maintenance is often observed for products that do not seem to require any retailer services at all, including "pet food, vitamins, shampoo, men's underwear," and so on.[431] Why do you think this is?
10) Suppose that Manufacturer X has operated an unrestricted distribution system for some years, but over time one or two retailers have become leaders in each state. Following a retailers' conference, these leading retailers jointly recommend that Manufacturer X grant them each exclusive territorial status in their respective states, including provisions that prevent them from selling into each other's territories, and phase out supply to other retailers. The leading retailers do not tell Manufacturer X that they were also motivated by concern that competition among them is hurting their pricing and profits, and that they would do better if they could divide the national market into cosy exclusive territories. Manufacturer X analyzes the proposal, agrees that it would improve demand and output, and implements it.
    a. What standard of review should apply to the agreement: *per se* or rule of reason? If the latter, under what circumstances would it be unlawful?

[428] *See generally*, *e.g.*, Stephen Martin & John T. Scott, GTE Sylvania *and Interbrand Competition as the Primary Concern of Antitrust Law*, 51 Rev. Ind. Org. 217 (2017).

[429] *See*, *e.g.*, William S. Comanor & Patrick Rey, *Vertical Restraints and the Market Power of Large Distributors*, 17 Rev. Indus. Org. 135 (2000) (identifying one mechanism through which intrabrand restraints could play a role in suppressing interbrand competition).

[430] *See*, *e.g.*, Daniel A. Crane, *Ecosystem Competition and the Antitrust Laws*, 98 Neb. L. Rev. 412 (2019); Autorité de la Concurrence & Competition & Markets Authority, THE ECONOMICS OF OPEN AND CLOSED SYSTEMS (Dec. 2014); Hanno F. Kaiser, *Are "Closed Systems" an Antitrust Problem?*, 7 Comp. Pol'y Int'l 91 (2011).

[431] Marina Lao, *Free Riding: An Overstated, and Unconvincing, Explanation for Resale Price Maintenance*, in Robert Pitofsky (ed.) HOW THE CHICAGO SCHOOL OVERSHOT THE MARK: THE EFFECT OF CONSERVATIVE ECONOMIC ANALYSIS ON U.S. ANTITRUST (2008) 201.

b. Would it affect your answer if the retailers had informally agreed, before Manufacturer X adopted the proposal, that they would do their best to respect the terms of the proposal while waiting for Manufacturer X's decision?

11) Is the modern approach to distribution restraints better or worse for consumers than the previous, per se-based approach? What informs your belief?
12) What was lost or sacrificed when the law of vertical restraints made the turn in *Sylvania*? What was gained? Was it worth the trade?
13) As you have seen, a standard justification for manufacturer-imposed vertical restraints is that, by guaranteeing some retail margin, they can make it possible for downstream retailers to undertake certain desirable services. Thinking back to what you read in Chapter V: would courts permit the same retailers to enter into a *purely horizontal* agreement that limited competition among them for the same purpose? If the result would be different: why?[432]

D. Exclusivity

Perhaps the most obvious form of vertical restraint on interbrand competition is the exclusivity agreement: that is, a commitment given by an upstream or downstream firm (say, an input supplier or a distributor) that it will refrain, in whole or part, from dealing with the competitors of its trading partner.

The possible threat to competition from such agreements is fairly clear. If a dominant firm extracts an exclusivity commitment from a critical input-supplier, or from a key distributor, then the dominant firm's market power may be protected and enhanced through the foreclosure of rivals, leaving them with insufficient, lower-quality, or higher-cost inputs or distribution. The effect is often summarized as "raising rivals' costs" (or just "RRC").[433] But although exclusivity may cause harms, we will also see in this Section that it can play an important role in generating benefits, including by supporting investments of various kinds.

Exclusivity agreements may be analyzed under either Section 1 of the Sherman Act or Section 3 of the Clayton Act (as well as Section 2 if a monopolist is the one imposing exclusivity). Some courts have indicated that, if an exclusivity agreement is imposed by a seller, only the seller imposing it—not buyers that accept it—will be liable.[434]

Clayton Act Section 3

You may remember from Chapter I that, in 1914, the Clayton Act introduced some conduct prohibitions intended to reinforce the Sherman Act. One of these is Section 3 of the Clayton Act, 15 U.S.C. § 14. It provides in relevant part: "It shall be unlawful for any person engaged in commerce, in the course of such commerce, to lease or make a sale or contract for sale of goods . . . or other commodities, whether patented or unpatented, for use, consumption, or resale within the United States or any Territory thereof or the District of Columbia . . . or fix a price charged therefor, or discount from, or rebate upon, such price, on the condition, agreement, or understanding that the lessee or purchaser thereof shall not use or deal in the goods . . . or other commodities of

[432] We owe this question to Sanjukta Paul.

[433] *See*, seminally, Thomas G. Krattenmaker & Steven C. Salop, *Anticompetitive Exclusion: Raising Rivals' Costs to Achieve Power over Price*, 96 Yale L.J. 209, 211 (1986).

[434] This is supported by the text of Section 3 of the Clayton Act, though Section 1 of the Sherman Act implies no such limitation. *See, e.g.*, Genetic Sys. Corp. v. Abbott Labs., 691 F. Supp. 407, 414 (D.D.C. 1988) ("Though few courts have ever addressed the issue, plaintiff has not pointed to any case where a court found a purchaser liable for an exclusive dealing contract, and it appears from the plain language of the statute, the relevant legislative history, and the observations of commentators that Section 3 does not impose liability on purchasers for exclusive dealing contracts. . . . This conclusion, drawn from the clear import of the statutory language, is also consistent with the fundamental antitrust concept that the alleged sins of sellers should not be visited on buyers because of the risk of chilling competition. . . . plaintiff has cited no case where a purchaser has been considered a proper defendant in an exclusive dealing contract case under Section 3 of the Clayton Act or Section 1 of the Sherman Act."); Truck-Lite Co., LLC v. Grote Indus., Inc., No. 18-CV-599, 2021 WL 8322467, at *15 (W.D.N.Y. Sept. 17, 2021) ("The language of [Section 3 of the Clayton Act] defines liability in terms of a person who makes a sale or contracts for sale and nowhere provides for liability of the buyer."); Marion Healthcare, LLC v. S. Illinois Healthcare, No. 12-CV-871, 2015 WL 3466585, at *5 (S.D. Ill. May 29, 2015) (applying the no-liability-for-buyers rule under Section 1 of the Sherman Act even when the buyer was alleged to have aggressively promoted the imposition of exclusivity); *see also* McGuire v. Columbia Broad. Sys., Inc., 399 F.2d 902, 906 (9th Cir. 1968) ("General Foods is not the seller, and consequently no cause of action is created against it [under Section 3].").

a competitor or competitors of the lessor or seller, where the effect of such lease, sale, or contract for sale or such condition, agreement, or understanding may be to substantially lessen competition or tend to create a monopoly in any line of commerce." On its face, this covers the use of exclusivity; it has been held to cover tying too.[435]

Section 3 exhibits some interesting differences from Section 1. For one thing, Section 3 does not on its face state that an agreement is required—a "condition" is enough—although courts generally appear to require an agreement.[436] For another thing, Section 3 is limited to commodities: thus, exclusivity and tying in services fall outside Section 3.[437] And, for a third thing, Section 3 provides only for the liability of a seller, not a buyer: thus, it would not apply to a buyer who agreed only to purchase from sellers that did not supply its rivals.[438]

Today, Section 3 is often construed consistently with the Sherman Act,[439] despite the fact that Congressional intent appears to have been to set up a somewhat more demanding standard,[440] and some cases imply that liability is a little easier to establish under Section 3, when that provision applies, than under Section 1.[441] In practice, courts today very seldom make much hay out of the difference between Section 1 and Section 3.

The legal standard against which exclusivity agreements are evaluated has changed over time. Perhaps the seminal pre-modern case is *Standard Stations* in 1949.[442] In *Standard Stations*, the Court held that—although exclusivity commitments offered the possibility of some benefits to competition—illegality could be inferred, at least under Section 3, from the fact that exclusivity had been used by the "major competitor" defendant with independent service stations that represented 16% of the retail outlets, and accounted for just 6.7% of all gasoline sales, in a multistate "Western Area."[443] In doing so, the Court held that the relevant arrangements could fairly be described as violating a prohibition on exclusivity that forecloses a "substantial share of the line of commerce affected."[444]

The notion of "substantial foreclosure" has survived and is foundational to the modern law of exclusivity, although the application of it in *Standard Stations* no longer represents the law. Today, "substantial foreclosure" means something like "material impairment of access to relevant input or distribution, sufficient to impose a burden on

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[435] *See*, *e.g.*, IBM Corp. v. United States, 298 U.S. 131, 135 (1936).

[436] Insulate SB, Inc. v. Advanced Finishing Sys., Inc., 797 F.3d 538, 543 (8th Cir. 2015); Roland Mach. Co. v. Dresser Indus., Inc., 749 F.2d 380 (7th Cir. 1984); SolarCity Corp. v. Salt River Project Agric. Improvement, No. CV-15-00374, 2015 WL 6503439, at *10 (D. Ariz. Oct. 27, 2015).

[437] Sheridan v. Marathon Petroleum Co. LLC, 530 F.3d 590, 592 (7th Cir. 2008) ("The tying arrangement is challenged under section 1 of the Sherman Act rather than section 3 of the Clayton Act because the things alleged to be tied—the franchise and the processing service—are services rather than commodities."); Chelson v. Oregonian Pub. Co., 715 F.2d 1368, 1372 (9th Cir. 1983) (holding that Section 3 applied because "[t]he agreement between the dealers and Oregonian provides that the dealers purchase the newspapers, which are goods, from Oregonian and resell them to readers").

[438] Genetic Sys. Corp. v. Abbott Labs., 691 F. Supp. 407, 414 (D.D.C. 1988).

[439] Sheridan v. Marathon Petroleum Co. LLC, 530 F.3d 590, 592 (7th Cir. 2008) ("Though some old cases say otherwise, the standards for adjudicating tying under the two statutes are now recognized to be the same."); Roland Machinery Co. v. Dresser Industries, Inc., 749 F.2d 380, 393 (7th Cir. 1984) (exclusivity now analyzed under the rule of reason under Section 1 and Section 3); *see also* Dos Santos v. Columbus-Cuneo-Cabrini Med. Ctr., 684 F.2d 1346, 1352 n. 11 (7th Cir. 1982) ("*Tampa Electric* is applicable to Sherman Act section 1 cases even though it was decided under section 3 of the Clayton Act[.]").

[440] *See*, *e.g.*, Standard Oil Co. of California v. United States, 337 U.S. 293, 312 (1949) ("It seems hardly likely that, having with one hand set up an express prohibition against a practice thought to be beyond the reach of the Sherman Act, Congress meant, with the other hand, to reestablish the necessity of meeting the same tests of detriment to the public interest as that Act had been interpreted as requiring.").

[441] *See*, *e.g.*, CDC Techs., Inc. v. IDEXX Labs., Inc., 186 F.3d 74, 79 (2d Cir. 1999) ("The conclusion that a contract does not violate § 3 of the Clayton Act ordinarily implies the conclusion that the contract does not violate the Sherman Act.") (citation omitted); Barr Labs., Inc. v. Abbott Labs., 978 F.2d 98, 110 (3d Cir. 1992) ("more rigorous standards of section 3 of the Clayton Act"); Twin City Sportservice, Inc. v. Charles O. Finley & Co., 676 F.2d 1291, 1304 n.9 (9th Cir.1982) ("[A] greater showing of anticompetitive effect is required to establish a Sherman Act violation than a section 3 Clayton Act violation in exclusive-dealing cases.").

[442] *See*, *e.g.*, Standard Oil Co. of California v. United States, 337 U.S. 293 (1949).

[443] Standard Oil Co. of California v. United States, 337 U.S. 293, 295 (1949).

[444] Standard Oil Co. of California v. United States, 337 U.S. 293, 314 (1949).

actual or potential rivals and threaten harm to competition."[445] Courts assess foreclosure in a variety of ways, and in doing so often evaluate the proportion of the input or distribution market that has been denied to rivals.[446]

The leading Supreme Court case on exclusivity agreements, and on the concept of substantial foreclosure, is *Tampa Electric*.[447] That case was decided under Section 3 of the Clayton Act, but has subsequently been accepted as a touchstone for the analysis of exclusivity under the Sherman Act as well. In that case, the Court held that an exclusivity agreement could not violate the law when it foreclosed only a trivial share of the relevant market. Something more—*substantial* foreclosure—was required.

Tampa Elec. Co. v. Nashville Coal Co.

365 U.S. 320 (1961)

Justice Clark.

[1] Petitioner Tampa Electric Company is a public utility located in Tampa, Florida. It produces and sells electric energy to a service area, including the city . . . . In 1955 Tampa Electric decided to expand its facilities by the construction of an additional generating plant to be comprised ultimately of six generating units, and to be known as the Francis J. Gannon Station. . . . Accordingly, it contracted with the respondents[, Nashville Coal Co.,] to furnish the expected coal requirements for the units. The agreement, dated May 23, 1955, embraced Tampa Electric's "total requirements of fuel . . . for the operation of its first two units to be installed at the Gannon Station . . . ," for a period of 20 years. The contract further provided that "if during the first 10 years of the term . . . the Buyer constructs additional units (at Gannon) in which coal is used as the fuel, it shall give the Seller notice thereof two years prior to the completion of such unit or units and upon completion of same the fuel requirements thereof shall be added to this contract." . . .

[2] In April 1957, soon before the first coal was actually to be delivered and after Tampa Electric, in order to equip its first two Gannon units for the use of coal, had expended some $3,000,000 more than the cost of constructing oil-burning units, and after respondents had expended approximately $7,500,000 readying themselves to perform the contract, the latter advised petitioner that the contract was illegal under the antitrust laws, would therefore not be performed, and no coal would be delivered. This turn of events required Tampa Electric to look elsewhere for its coal requirements. . . . .

[3] The record indicates that the total consumption of coal in peninsular Florida, as of 1958, aside from Gannon Station, was approximately 700,000 tons annually. It further shows that there were some 700 coal suppliers in the producing area where respondents operated, and that Tampa Electric's anticipated maximum requirements at Gannon Station, i.e., 2,250 tons annually, would approximate 1% of the total coal of the same type produced and marketed from respondents' producing area.

[4] Petitioner brought this suit in the District Court . . . for a declaration that its contract with respondents was valid, and for enforcement according to its terms. In addition to its Clayton Act defense, respondents contended that the contract violated both ss 1 and 2 of the Sherman Act which, it claimed, likewise precluded its enforcement. [. . .]

[5] In practical application, even though a contract is found to be an exclusive-dealing arrangement, it does not violate the section unless the court believes it probable that performance of the contract will foreclose competition

[445] For a thoughtful discussion, *see* Joshua D. Wright & Alexander Krzepicki, *Rethinking Foreclosure Analysis in Antitrust Law: From Standard Stations to Google*, Concurrentialiste (Dec. 17, 2020), https://www.networklawreview.org/wright-krzepicki-foreclosure/.

[446] *See*, *e.g.*, United States v. Microsoft Corp., 253 F.3d 34, 70 (D.C. Cir. 2001) (en banc) (contract must foreclosure "roughly 40% or 50% share" of the market to violate Section 1). Calculating this share can raise some complexities. *See*, *e.g.*, Joshua D. Wright, *Moving Beyond Naïve Foreclosure Analysis*, 19 Geo. Mason L. Rev. 1163, 1165 (2012) (proposing "assessing the foreclosure attributable to the defendant's conduct as a result of the business practice at issue by comparing foreclosure under the restraint as observed with a "but-for" analysis of the share of the input market the defendant would occupy in the absence of such an agreement").

[447] Tampa Elec. Co. v. Nashville Coal Co., 365 U.S. 320 (1961). The earlier *Standard Stations* case had emphasized the centrality of the amount of foreclosure resulting from a challenged practice. *Standard Oil Co. of California v. United States*, 337 U.S. 293, 314 (1949) (holding that condemnation under Section 3 of the Clayton Act requires "proof that competition has been foreclosed in a substantial share of the line of commerce affected").

in a substantial share of the line of commerce affected. Following the guidelines of earlier decisions, certain considerations must be taken. First, the line of commerce, i.e., the type of goods, wares, or merchandise, etc., involved must be determined, where it is in controversy, on the basis of the facts peculiar to the case. Second, the area of effective competition in the known line of commerce must be charted by careful selection of the market area in which the seller operates, and to which the purchaser can practicably turn for supplies. In short, the threatened foreclosure of competition must be in relation to the market affected. [. . .]

[6] Third, and last, the competition foreclosed by the contract must be found to constitute a substantial share of the relevant market. That is to say, the opportunities for other traders to enter into or remain in that market must be significantly limited as was pointed out in *Standard Oil Co. v. United States*[, 337 U.S. 293 (1949)]. There the impact of the requirements contracts was studied in the setting of the large number of gasoline stations—5,937 or 16% of the retail outlets in the relevant market—and the large number of contracts, over 8,000, together with the great volume of products involved. This combination dictated a finding that Standard's use of the contracts created just such a potential clog on competition as it was the purpose of s 3 [of the Clayton Act] to remove where, as there, the affected proportion of retail sales was substantial. . . . [I]n *United States v. Columbia Steel Co.*[, 334 U.S. 495 (1948)], substantiality was judged on a comparative basis, *i.e.*, Consolidated's use of rolled steel was "a small part" when weighed against the total volume of that product in the relevant market.

[7] To determine substantiality in a given case, it is necessary to weigh the probable effect of the contract on the relevant area of effective competition, taking into account the relative strength of the parties, the proportionate volume of commerce involved in relation to the total volume of commerce in the relevant market area, and the probable immediate and future effects which pre-emption of that share of the market might have on effective competition therein. It follows that a mere showing that the contract itself involves a substantial number of dollars is ordinarily of little consequence. [. . .]

[8] Neither the Court of Appeals nor the District Court considered in detail the question of the relevant market. They do seem, however, to have been satisfied with inquiring only as to competition within "Peninsular Florida." It was noted that the total consumption of peninsular Florida was 700,000 tons of coal per year, about equal to the estimated 1959 requirements of Tampa Electric. It was also pointed out that coal accounted for less than 6% of the fuel consumed in the entire State. The District Court concluded that though the respondents were only one of 700 coal producers who could serve the same market, [*i.e.*,] peninsular Florida, the contract for a period of 20 years excluded competitors from a substantial amount of trade. . . . [But] Tampa Electric says that both courts and respondents are in error, because the 700 coal producers who could serve it, as recognized by the trial court and admitted by respondents, operated in the Appalachian coal area and that its contract requirements were less than 1% of the total marketed production of these producers; that the relevant effective area of competition was the area in which these producers operated, and in which they were willing to compete for the consumer potential.

[9] By far the bulk of the overwhelming tonnage marketed from the same producing area as serves Tampa is sold outside of Georgia and Florida, and the producers were "eager" to sell more coal in those States. While the relevant competitive market is not ordinarily susceptible to a "metes and bounds" definition, it is of course the area in which [Nashville Coal Co.] and the other 700 [coal] producers effectively compete. . . . We also note that in 1954 Florida and Georgia combined consumed at least 2,304,000 tons, 1,100,000 of which were used by electric utilities, and the sources of which were mines located in no less than seven States. . . . From these statistics it clearly appears that the proportionate volume of the total relevant coal product as to which the challenged contract pre-empted competition, less than 1%, is, conservatively speaking, quite insubstantial. A more accurate figure, even assuming pre-emption to the extent of the maximum anticipated total requirements, 2,250,000 tons a year, would be .77%.

[10] . . . It is urged that the present contract pre-empts competition to the extent of purchases worth perhaps $128,000,000, and that this is, of course, not insignificant or insubstantial. While $128,000,000 is a considerable sum of money, even in these days, the dollar volume, by itself, is not the test, as we have already pointed out.

[11] The remaining determination, therefore, is whether the pre-emption of competition to the extent of the tonnage involved tends to substantially foreclose competition in the relevant coal market. We think not. That market sees an annual trade in excess of 250,000,000 tons of coal and over a billion dollars—multiplied by 20 years it runs into astronomical figures. There is here neither a seller with a dominant position in the market . . . ;

nor myriad outlets with substantial sales volume, coupled with an industry-wide practice of relying upon exclusive contracts . . . ; nor a plainly restrictive tying arrangement . . . . On the contrary, we seem to have only that type of contract which may well be of economic advantage to buyers as well as to sellers. In the case of the buyer it may assure supply, while on the part of the seller it may make possible the substantial reduction of selling expenses, give protection against price fluctuations, and offer the possibility of a predictable market. The 20-year period of the contract is singled out as the principal vice, but at least in the case of public utilities the assurance of a steady and ample supply of fuel is necessary in the public interest. Otherwise consumers are left unprotected against service failures owing to shutdowns; and increasingly unjustified costs might result in more burdensome rate structures eventually to be reflected in the consumer's bill. The compelling validity of such considerations has been recognized fully in the natural gas public utility field. This is not to say that utilities are immunized from Clayton Act proscriptions, but merely that, in judging the term of a requirements contract in relation to the substantiality of the foreclosure of competition, particularized considerations of the parties' operations are not irrelevant. In weighing the various factors, we have decided that in the competitive bituminous coal marketing area involved here the contract sued upon does not tend to foreclose a substantial volume of competition.

[12] We need not discuss the respondents' further contention that the contract also violates s 1 and s 2 of the Sherman Act, for if it does not fall within the broader proscription of s 3 of the Clayton Act it follows that it is not forbidden by those of the former.

Incentivizing, Rather than Strictly Requiring, Exclusivity: The* Surescripts *Litigation

FTC v. Surescripts, LLC, 424 F. Supp. 3d 92 (D.D.C. 2020)

In an exclusivity case, as we have noted, the source of the harm to competition is usually the impairment ("foreclosure") of rivals' access to inputs, distribution, customers, or complements, and the resulting reduction in their ability to exert competitive discipline on a market participant with market or monopoly power.[448] Sometimes the relevant impairment may involve a formal contractual commitment that leaves suppliers or distributors "locked in" for a long period of time. But harm to competition can arise without anything of the kind: and even with no contract at all, as in the case of unilateral conditional-dealing policies, as we will see in Chapter VII.[449] Importantly, an equivalent effect—"de facto exclusivity"—can often be created by simply offering preferential terms, such as low prices, as an incentive for exclusive trading. And, just as with traditional exclusivity, this can be structured either as an agreement between the parties (*e.g.*, a contract providing for a sale price X for a period in which the trading partner deals exclusively with the defendant and a, higher, sale price Y for during other periods) or simply from a unilateral conditional-dealing policy of offering better terms to partners that do not deal with rivals.[450] (Of course, the latter would be vulnerable to challenge under Section 2 but not Section 1.)

The FTC's lawsuit against the e-prescribing platform Surescripts illustrates de facto exclusivity in action. Surescripts operated a market-leading platform that connected insurers to healthcare providers, and healthcare providers to pharmacies. The FTC's enforcement action—which was brought under Section 2, rather than Section 1, although the distinction is immaterial for present purposes—involved a challenge to the use of contractual "loyalty pricing" by Surescripts. In particular, the FTC's complaint alleged that "[b]eginning in mid-2009, Surescripts devised a scheme to include 'loyalty' provisions in contracts with customers on both sides of the routing and eligibility markets, which conditioned discounts or payments on actual or de facto exclusivity [with Surescripts]." In order to qualify for a loyalty discount under this scheme, the FTC alleged, "a customer must be exclusive to Surescripts," and "[t]o be considered exclusive, Surescripts requires that a pharmacy and PTV customer route 100% of its transactions through and only through the Surescripts network." The FTC alleged

[448] *See supra* note 433 and accompanying text.

[449] *See, e.g.*, Lorain Journal Co. v. United States, 342 U.S. 143 (1951).

[450] *See, e.g.*, Roland Machinery Co. v. Dresser Industries, Inc., 749 F.2d 380 (7th Cir. 1984) ("One mind is not enough for a meeting of minds. The fact that Dresser was hostile to dealers who would not live and die by its product . . . and acted on its hostility by canceling a dealer who did the thing to which it was hostile, does not establish an agreement, but if anything the opposite: a failure to agree on a point critical to one of the parties.").

that Surescripts' executives "repeatedly admitted that Surescripts's web of exclusive contracts quashed any competitive threat."

Surescripts moved to dismiss the complaint. Among other things, it emphasized that its loyalty programs "are entirely optional and thus do not necessarily constitute exclusive contracts." But Judge Bates of the U.S. District Court for the District of Columbia was not persuaded: "[A] contract need not contain specific agreements not to use the services of a competitor as long as the practical effect is to prevent such use. The FTC alleges that the threat of increased prices had the practical effect of preventing customers from working with other e-prescribing platforms, since doing so would trigger the massive penalty provisions in their contracts with Surescripts and cost routing and eligibility customers millions of dollars through increased prices . . . [T]he test of whether a monopolist forecloses competition is not total foreclosure, but whether the challenged practices bar a substantial number of rivals or severely restrict the market's ambit. Here, the government has pleaded facts demonstrating such substantial foreclosure." In other words, it was enough that the agreements strongly *incentivized* exclusivity, even if they did not literally require it.

Surescripts tried a different tack, arguing that "the FTC failed to plead sufficient facts showing that Surescripts's business practices foreclosed market competition to a 'substantial' degree," on the basis that "exclusive dealing is illegal only if the arrangement 'substantially' weakens competition, and . . . its contracts, even if facially exclusive, were easily terminable, of short duration, and therefore presumptively lawful." But this, too, failed to move the court. "Even if the contracts were short term and easily terminable," the court pointed out, "the FTC argues that their exclusive terms, when combined with the nature of the two relevant markets and Surescripts's dominant monopoly position, had the effect of foreclosing large parts of both markets and harming competition." In so doing, the court implicitly underscored the importance of economic substance, rather than legal form: even short-term, easily-terminated agreements can strongly incentivize exclusivity and harm competition. More generally, *Surescripts* demonstrates that even agreements and practices that do not literally require the counterparty to completely terminate all dealings with the defendant's rivals can have a directional effect equivalent to exclusivity, by deterring and restricting such dealings.

Despite the potential for competitive harm under particular circumstances, exclusivity agreements are fairly common in the economy, and are often used by businesses that lack market or monopoly power.[451] As long ago as *Standard Stations* (1949) the Court acknowledged the possible benefits of exclusive agreements (although how many of these benefits are traceable to exclusivity rather than what the counterparty is presumed to be getting in return for its commitment?):

> In the case of the buyer, they may assure supply, afford protection against rises in price, enable long-term planning on the basis of known costs, and obviate the expense and risk of storage in the quantity necessary for a commodity having a fluctuating demand. From the seller's point of view, requirements contracts may make possible the substantial reduction of selling expenses, give protection against price fluctuations, and—of particular advantage to a newcomer to the field to whom it is important to know what capital expenditures are justified—offer the possibility of a predictable market.[452]

Indeed, exclusive agreements may play a critical role in making certain kinds of investment and cooperation possible, as the following extracts point out.

In *Roland Machinery*, the plaintiff, Roland, was a distributor of construction equipment that was cut off by a manufacturer, Dresser, when Roland started distributing a second line of equipment manufactured by Dresser's competitor, Komatsu. Roland sued under Section 3 of the Clayton Act, alleging that Dresser's termination was pursuant to an unlawful implicit exclusive agreement between Dresser and Roland. The trial court below was persuaded to grant a preliminary injunction which prevented Dresser from cutting Roland off during the litigation.

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[451] Francine Lafontaine & Margaret Slade, *Exclusive Contracts and Vertical Restraints: Empirical Evidence and Public Policy* in Paolo Buccirossi (ed.), HANDBOOK OF ANTITRUST ECONOMICS (2008) 392 ("In most western economies, a large fraction of retail sales through independent retailers is subject to some form of exclusive-dealing clauses. For example, in the U.S., that fraction is over one third.").

[452] Standard Oil Co. of California v. United States, 337 U.S. 293, 306–07 (1949).

On appeal, the Seventh Circuit was much less enthusiastic. In the article extract that follows the extract from *Roland Machinery*, Benjamin Klein and Andres Lerner set out some circumstances under which exclusivity may play a role in protecting against free riding.

Roland Machinery Co. v. Dresser Industries, Inc.

749 F.2d 380 (7th Cir. 1984)

Judge Posner.

[1] Roland Machinery Company, a substantial dealer . . . in construction equipment and related items, serving a 45-county area in central Illinois, was for many years the area's exclusive distributor of International Harvester's line of construction equipment. International Harvester got into serious financial trouble and in 1982 sold its construction-equipment division to Dresser Industries. Dresser promptly signed a dealership agreement with Roland. The agreement provided that it could be terminated by either party, without cause, on 90 days' notice. It did not contain an exclusive-dealing clause (that is, a clause forbidding the dealer to sell any competing manufacturer's construction equipment). Eight months after signing the agreement Roland signed a similar agreement with Komatsu, a Japanese manufacturer of construction equipment. Several months after discovering that Roland had done this, Dresser gave notice that it would exercise its contract right to terminate its dealership agreement with Roland without cause. Roland brought this suit shortly before the end of the 90-day notice period, charging that Dresser had violated section 3 of the Clayton Act and other provisions of federal and state law. The district judge granted Roland a preliminary injunction based solely on the section 3 charges, and Dresser has appealed . . . . None of Roland's other charges is before us on this appeal.

[2] At the hearing on Roland's motion for preliminary injunction, Dresser presented evidence that it had cut off Roland because it was afraid that Roland intended to phase out the Dresser line and become an exclusive Komatsu dealer, and because it believed that as long as Roland (a well-established firm) remained a Dresser dealer, no other dealer in the area would be willing to handle Dresser equipment, as this would mean competing with Roland. The usual practice in the industry is for dealers not to carry competing lines, and Dresser presented evidence that this makes for more aggressive promotion of each line. Roland, however, presented evidence that it had no intention of phasing out Dresser equipment, that it was terminated because the dealership contract contained what Roland at argument called a "secret" term requiring Roland to deal exclusively in Dresser equipment, and that the sudden termination would bankrupt it or at least cause it serious loss. But it seems that only about 50 percent of Roland's revenues are derived directly or indirectly from Dresser equipment, and only about 10 percent from selling new Dresser equipment (the other 40 percent coming from renting and servicing equipment, and from selling parts); and Dresser argues that Roland could survive simply by promoting Komatsu equipment aggressively—which it intended to do anyway. [. . .]

[3] On the probable merits of Roland's section 3 claim, the judge found that while Dresser's contract with Roland contained no exclusive-dealing requirement, Roland has adequately shown that an implied exclusive dealing arrangement existed between itself and Dresser. [. . .]

[4] In order to prevail on its section 3 claim, Roland will have to show both that there was an agreement, though not necessarily an explicit agreement, between it and Dresser that it not carry a line of construction equipment competitive with Dresser's, and that the agreement was likely to have a substantial though not necessarily an immediate anticompetitive effect. Regarding the first of these required showings, the record of the preliminary-injunction proceeding contains no evidence that either Roland or any other Dresser dealer agreed with Dresser not to carry a competing manufacturer's line. Nothing in the dealership agreement even hints at a requirement of exclusive dealing, and the fact that after signing the agreement with Dresser, Roland applied for a Komatsu dealership is evidence that Roland itself did not think it had made an implied commitment to exclusive dealing. True, Dresser prefers exclusive dealers—so much so as to be willing to terminate its only dealer in a large marketing area. The district judge believed that evidence of this preference, coupled with the absence of any reason for Dresser's having terminated Roland other than Roland's having taken on an additional line of construction equipment, established a prima facie case of agreement. But an agreement requires a meeting of minds, and there is no evidence that Roland ever thought itself bound to carry only the Dresser line. Indeed, at

argument Roland disclaimed any knowledge of what it describes as the implied exclusive-dealing term in the contract; it called it a "secret" term, echoing the district judge's description of exclusive dealing as something "in the mind of" Dresser. One mind is not enough for a meeting of minds. The fact that Dresser was hostile to dealers who would not live and die by its product (as the district judge put it), and acted on its hostility by canceling a dealer who did the thing to which it was hostile, does not establish an agreement, but if anything the opposite: a failure to agree on a point critical to one of the parties.

[5] Actually, it is not important whether Dresser's antipathy to nonexclusive dealing was secret. Assume that Dresser made clear to Roland and its other dealers that it wanted only exclusive dealers and would exercise its contract right to terminate, immediately and without cause, any dealer who took on a competing line. The mere announcement of such a policy, and the carrying out of it by canceling Roland or any other noncomplying dealer, would not establish an agreement. . . .

[6] Dresser's preference for exclusive dealers, its efforts to find out whether its dealers were exclusive dealers, and its terminating Roland when it found out that Roland no longer was its exclusive dealer do not support an inference both that the distributor communicated its acquiescence or agreement to exclusive dealing and that this was sought by the manufacturer. But even if Roland can prove at trial that there was an exclusive-dealing agreement, it will have grave difficulty—we infer from this record—in proving that the agreement is anticompetitive. The objection to exclusive-dealing agreements is that they deny outlets to a competitor during the term of the agreement. At one time it was thought that this effect alone would condemn exclusive-dealing agreements under section 3 of the Clayton Act, provided that the agreements covered a large fraction of the market. Although the Supreme Court has not decided an exclusive-dealing case in many years, it now appears most unlikely that such agreements, whether challenged under section 3 of the Clayton Act or section 1 of the Sherman Act, will be judged by the simple and strict test of [earlier law]. They will be judged under the Rule of Reason, and thus condemned only if found to restrain trade unreasonably.

[7] The exclusion of competitors is cause for antitrust concern only if it impairs the health of the competitive process itself. Hence a plaintiff must prove two things to show that an exclusive-dealing agreement is unreasonable. First, he must prove that it is likely to keep at least one significant competitor of the defendant from doing business in a relevant market. If there is no exclusion of a significant competitor, the agreement cannot possibly harm competition. Second, he must prove that the probable (not certain) effect of the exclusion will be to raise prices above (and therefore reduce output below) the competitive level, or otherwise injure competition; he must show in other words that the anticompetitive effects (if any) of the exclusion outweigh any benefits to competition from it.

[8] Roland has as yet made very little effort to establish either of these two things. On the present record it appears that Komatsu cannot be kept out of the central Illinois market even if every manufacturer of construction equipment prefers exclusive dealers and will cancel any dealer who switches to the Komatsu line. Komatsu is the second largest manufacturer of construction equipment in the world. Its total sales of such equipment are four times as great as Dresser's. Already it is a major factor in the U.S. construction-equipment market; in some items it outsells Dresser. The nationwide practice of exclusive dealing has not kept Komatsu from becoming a major factor in the U.S. market, apparently in a short period of time. The reason is evident. Since dealership agreements in this industry are terminable by either party on short notice, Komatsu, to obtain its own exclusive dealer in some area, has only to offer a better deal to some other manufacturer's dealer in the area. It need not fear being sued for interference with contract; Roland would not be breaking its contract with Dresser if it gave Dresser the heave-ho, provided it gave 90 days' notice. Maybe if Roland had known that it would be cut off by Dresser as soon as it was, it would have demanded some guarantees from Komatsu to tide it over the period of transition when Komatsu was not yet as well established a name in central Illinois as Dresser (though Dresser itself was in a sense new to the market); and probably Komatsu would have given Roland these guarantees to get a foothold in the central Illinois market. The likeliest consequence of our dissolving the preliminary injunction would be to accelerate Komatsu's efforts to promote its brand through the Roland dealership.

[9] Admittedly this analysis may exaggerate the smoothness with which the competitive process operates. Knowing that it cannot move gradually into central Illinois by persuading dealers to carry its line as a second line, Komatsu may expand more slowly than it would otherwise have done, and at somewhat higher cost. And since the national

market in construction equipment appears to be highly concentrated (although the record is scanty in this regard, particularly in its omission of any data on foreign sales, which may conceivably be part of the U.S. market, properly defined), any impediments to new competition may harm consumers by keeping prices at noncompetitive levels—though whether the industry at present is or is not highly competitive must be a matter of conjecture on this record. But with all this conceded we still cannot agree that Roland has shown a substantial anticompetitive effect, actual or potential, from the alleged exclusive-dealing agreement, when we reflect on Komatsu's strength and on the fact that neither Dresser nor, it appears, any other manufacturer has long-term exclusive-dealing contracts. Exclusive-dealing contracts terminable in less than a year are presumptively lawful under section 3. This one was terminable in 90 days. Finally, Komatsu undoubtedly has the resources to establish its own dealership in central Illinois, if it cannot lure away someone else's dealer despite the lack of long-term contracts binding dealers to their existing suppliers.

[10] The calculus of competitive effect must . . . include some consideration of the possible competitive benefits of exclusive dealing in this industry. Competition is the allocation of resources in which economic welfare (consumer welfare, to oversimplify slightly) is maximized; it is not rivalry per se, or a particular form of rivalry, or some minimum number of competitors. If, as Dresser argues, exclusive dealing leads dealers to promote each manufacturer's brand more vigorously than would be the case under nonexclusive dealing, the quality-adjusted price to the consumer (where quality includes the information and other services that dealers render to their customers) may be lower with exclusive dealing than without, even though a collateral effect of exclusive dealing is to slow the pace at which new brands, such as Komatsu, are introduced. The evidence on this point is slim. But it is at least plausible that Dresser, having if we may judge from its operation in central Illinois only one dealer in a large territory, would want that dealer to devote his efforts entirely to selling Dresser's brand. A dealer who expresses his willingness to carry only one manufacturer's brand of a particular product indicates his commitment to pushing that brand; he doesn't have divided loyalties. If the dealer carries several brands, his stake in the success of each is reduced. Suppose, though there is contrary evidence in the record, that Roland intended to promote Dresser and Komatsu products with equal vigor. It is still the case that if Roland failed to promote Dresser vigorously, it would have Komatsu to fall back on—but Dresser might suffer a drastic decline in the central Illinois market, all of its eggs being in the Roland basket. Exclusive dealing may also enable a manufacturer to prevent dealers from taking a free ride on his efforts (for example, efforts in the form of national advertising) to promote his brand. The dealer who carried competing brands as well might switch customers to a lower-priced substitute on which he got a higher margin, thus defeating the manufacturer's effort to recover the costs of his promotional expenditures by charging the dealer a higher price.

[11] Therefore, even if, in signing on with Komatsu, Roland did not intend to discontinue its sales of the Dresser line eventually and in the meantime to begin phasing Dresser out, Dresser still has a plausible argument that an exclusive dealer would promote its line more effectively than a nonexclusive dealer, and by doing so would increase competition in the market for construction equipment. The argument is no more than plausible; it is supported by very little evidence; it may be wrong. But when we consider how tenuous is the evidence that exclusive dealing in this market will exclude or even significantly retard Komatsu—how tenuous even is the inference that there was an exclusive-dealing agreement—even weak evidence of competitive gains from exclusive dealing must reinforce our conclusion that Roland has failed to show that it is more likely than not to prevail at the trial on the merits.

[12] It should go without saying that although we have concluded that the district judge should not have granted Roland's motion for a preliminary injunction, our discussion of the probable merits of Roland's antitrust claim is tentative. We do not exclude the possibility that on the fuller record made in the trial on the merits Roland will succeed in establishing its claim.

Benjamin Klein & Andres V. Lerner, The Expanded Economics of Free-Riding: How Exclusive Dealing Prevents Free-Riding and Creates Undivided Loyalty

74 Antitrust L.J. 473 (2007)

Dealers often have an insufficient incentive to supply the quantity of brand-specific promotion that maximizes manufacturer profitability because they earn less profit than the manufacturer on their promotional efforts. This is because the manufacturer's profit margin on the incremental sales induced by dealer promotion often is significantly greater than the dealer's incremental profit margin and because the manufacturer's quantity increase from brand-specific dealer promotion is significantly greater than the dealer's quantity increase. These differential quantity effects are a consequence of the fact that brand-specific dealer promotion primarily shifts consumer purchases to the promoted brand from other brands without causing consumers to shift their purchases between dealers. In these circumstances dealers will find it in their independent economic interests to supply less brand-specific promotion than is desired by a manufacturer, creating an incentive for manufacturers to compensate dealers for providing increased promotion of their products. [. . .]

Because dealers are supplying more brand-specific promotion under these arrangements than they would otherwise independently find profitable to supply, dealers can increase their short-run profits (before manufacturer detection and termination) by not providing the increased promotion they have been paid to supply. Dealers may profit in three economically distinct ways, each of which can usefully be described as dealer free-riding on the manufacturer because in all three cases dealers are taking advantage of the way in which the manufacturer is compensating dealers for increased promotion. The first type of dealer free-riding, which is the focus of standard economic and antitrust analysis of exclusive dealing, involves a dealer taking advantage of manufacturer-provided promotional investments, such as dealer sales training or display fixtures. These investments are supplied to dealers free of charge as a way for the manufacturer to subsidize brand-specific dealer promotion. Free-riding dealers then use these investments to sell alternative products on which they can earn greater profit. This form of dealer free-riding is clearly prevented with exclusive dealing since the dealer is prohibited from selling alternative products. Although this is a valid economic rationale for exclusive dealing, we demonstrate that this is not the only or most common form of free-riding that may be mitigated by exclusive dealing.

Whether or not a manufacturer supplies dealers with investments that the dealers can use to sell rival products, a second type of potential dealer free-riding exists when manufacturers pay dealers for supplying increased promotion. Dealers then have an economic incentive to use their promotional efforts purchased by the manufacturer to switch consumers to other products upon which they can earn greater profit. This dealer free-riding problem is shown to exist because dealer promotion compensation arrangements, such as exclusive territories, often pay dealers as a function of all their sales, not solely the incremental sales induced by the additional dealer promotion the manufacturer has purchased. Therefore, when a dealer uses its extra promotional efforts to sell another brand, it continues to receive most of the manufacturer's compensation for providing additional promotion while not promoting the manufacturer's products. Exclusive dealing can be used to prevent this second type of free-riding in the same way it prevents the first type of free-riding, by preventing dealers from using their promotional efforts that have been paid for by the manufacturer to sell alternative brands.

. . . [A] third form of potential dealer free-riding exists which may be mitigated by exclusive dealing. Rather than a dealer using manufacturer-supplied promotional investments or manufacturer paid-for dealer promotional efforts to promote the sale of other brands, a dealer may free-ride on the manufacturer merely by failing to supply the level of promotion for which the manufacturer has paid. Since dealers often are compensated for supplying additional promotion on the basis of all their sales, including sales the dealer would make even if it did not provide the additional promotional efforts it has been paid for, dealers have an incentive not to supply the additional promotion and continue to collect most of the manufacturer's compensation. Exclusive dealing is shown to mitigate this third type of free-riding by creating dealers with "undivided loyalty" that have an increased independent economic incentive to more actively promote the manufacturer's products. [. . .]

The expanded economic analysis of exclusive dealing presented in this article does not mean that exclusive dealing is always benign. In particular, the additional procompetitive efficiencies of exclusive dealing we describe may be outweighed in specific cases by potential anticompetitive effects of the exclusive dealing contract in foreclosing rivals. What it does mean, however, is that, because of the expanded legitimate procompetitive justifications that may be offered for exclusive dealing, balancing procompetitive efficiencies against potential anticompetitive effects will be required in many more exclusive dealing cases than previously believed.

NOTES

1) Who sued whom in *Tampa Electric* and why? What was the story of harm from exclusivity at issue? What do you think motivated the suit?

2) In appropriate circumstances, exclusive agreements can be challenged under Section 1 of the Sherman Act, Section 2 of the Sherman Act, and Section 3 of the Clayton Act. These three provisions have different language, histories, and purposes. When they apply to a common practice (like an exclusivity agreement obtained by a monopolist pertaining to the sale of a commodity), should the same analytical standard be applied across all three provisions?
3) The court in *Surescripts* said that "a contract need not contain specific agreements not to use the services of a competitor as long as the practical effect is to prevent such use." Suppose that a market participant with market power placed such a large order with an input supplier that, in practice, fulfilling the order would mean saying no to the participant's rivals. Under what circumstances, if any, should that order be analyzed as an exclusivity agreement? Would it affect your answer if:
    a. the business with market power genuinely needed the full amount of the order and had no idea whether it would impair the supplier's ability to sell to rivals?
    b. the business with market power did not strictly need the full amount of the order, but genuinely thought it prudent to build up a surplus, and also knew that the order would make it impossible to fully serve rivals?
    c. the business with market power had no real clue how much it needed, or what the impact would be on rivals, but placed the large order generally hoping that it would have the result of ensuring adequate supply for itself and insufficient supply for rivals?
4) Many businesses reward loyal customers with better terms. Suppose that a client asks you for general guidance on when a loyalty discount violates the antitrust laws. What would you say?
5) Should "coercion" be relevant to the assessment of the legality of an exclusive deal? If so, on what definition, and why?[453]
6) What does "free riding" mean in antitrust analysis, in your own words? Could "prevention of free riding" cover all occasions on which a monopolist prevents a competitor from doing something that would reduce the profitability of the monopoly?
7) In *Roland Machinery* Judge Posner said that, for an exclusivity agreement to be illegal, it must "keep at least one significant competitor of the defendant from doing business in a relevant market." Is that formulation an accurate statement of the "substantial foreclosure" test, or is it substantially more demanding? Can you imagine circumstances in which an agreement could harmfully and substantially foreclose competition without driving a rival out of the market?

E. Tying

Tying involves selling a product or service that customers desire (the "tying" product or service) only on the condition that the customers *also* purchase another product or service (the "tied" product or service). The core competitive concern in a tying case is that market power in the market for the tying product will be used to suppress demand for rivals' products in the tied market, and that competitive harm may result (*e.g.*, because tied-market rivals are unable to maintain viable scale).

It may immediately occur to you that there are many reasons why suppliers, as well as their trading partners, might find it efficient to sell and buy products and services together. Consumers often want to buy complete products—cars, computers, board games, pizzas, and so on—rather than to source and assemble individual components themselves: and suppliers very often would not find it commercially reasonable to sell individual components instead of integrated products. Indeed, it is central to the value proposition of products like smartphones and operating systems that they provide a broad array of functionalities to consumers right "out of the box," without requiring consumers to independently research and obtain specific solutions for a variety of needs. It is almost certainly a good thing, overall, that smartphone manufacturers can integrate a telephone, a digital camera, email software, and other products and services and supply them to consumers together. Any sensible tying law must, therefore, take account of these and similar benefits.

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[453] *See generally*, *e.g.*, Jean Wegmen Burns, *The New Role of Coercion in Antitrust*, 60 Fordham L. Rev. 379 (1991); Mark R. Patterson, *Coercion, Deception, and Other Demand-Increasing Practices in Antitrust Law*, 66 Antitrust L.J. 1 (1997).

Like exclusivity, tying cases can often be brought under Section 1 or under Section 2. They may also be brought under Section 3 of the Clayton Act, as the Supreme Court has held.[454] And just as with exclusivity, it may be necessary to distinguish between the competitive effects of a tying agreement (for example, a contract in which the customer commits to purchase the tied product only from the seller) and the effects of a seller's unilateral conditional-dealing policy (for example, a seller's unilateral policy of refusing to supply the tying product or service to anyone who buys the tied product or service from a rival).

The law of tying under Section 1 is a little peculiar. Among other things, as a matter of black-letter law, tying can be *per se* illegal. Indeed, this was the basic rule for many years.[455] In 1949 the Supreme Court put its name to the proposition that "tying arrangements service hardly any purpose beyond the suppression of competition,"[456] and in 1969 the Court condemned under the *per se* rule a home-builder that was offering credit on favorable terms to those who bought its houses.[457]

But for many decades courts have realized that a *per se* rule against tying—taken seriously and applied regardless of whether competitive harm was likely, and regardless of whether the tie would generate procompetitive benefits—would make very little economic, legal, or practical sense. As a result, today, courts vacillate somewhat between applying a very strained version of a *per se* rule, according to which *per se* scrutiny applies if certain preconditions are met, and applying something that amounts to the rule of reason. The usual preconditions for *per se* condemnation include: (1) the existence of economically separate products or services; (2) market power in the tying product market; (3) actual conditioning; (4) evidence—required by some, but not all, lower courts[458]—of actual or potential harm to competition in the tied product market (making this, in many courts, a nominally "*per se*" standard that approaches the rule of reason); and (5) the existence of a "not insubstantial" volume of interstate commerce affected by the tie.[459]

In practice, courts also often find a way to consider procompetitive benefits of ties, whether explicitly or implicitly: in the *Microsoft* case, for example, the D.C. Circuit simply held that "the rule of reason, rather than per se analysis, should govern the legality of tying arrangements involving platform software products," given the novelty of

[454] *See* Int'l Bus. Machines Corp. v. United States, 298 U.S. 131, 135 (1936).

[455] Int'l Salt Co. v. United States, 332 U.S. 392, 396 (1947) (analyzing tying clause and stating that "it is unreasonable, per se, to foreclose competitors from any substantial market,"), *abrogated by* Illinois Tool Works Inc. v. Indep. Ink, Inc., 547 U.S. 28 (2006).

[456] Standard Oil Co. of California v. United States, 337 U.S. 293, 305 (1949). *See also* Brown Shoe Co. v. United States, 370 U.S. 294, 330 (1962) (noting that tying is "inherently anticompetitive").

[457] Fortner Enterprises, Inc. v. U.S. Steel Corp., 394 U.S. 495, 498 (1969) ("Our cases have made clear that, at least when certain prerequisites are met, arrangements of this kind are illegal in and of themselves, and no specific showing of unreasonable competitive effect is required").

[458] *Compare*, *e.g.*, In re Cox Enterprises, Inc., 871 F.3d 1093, 1107 (10th Cir. 2017) ("[P]laintiffs alleging per se unlawful tying arrangements must do more to meet the foreclosure element than point to a dollar amount. . . . They must show that the alleged tying arrangement had the potential to or actually did injure competition."); *id.* at 1100 ("[E]ven if tying plaintiffs show that a tie affected a substantial dollar volume of sales, they must still show that the tie meets *Jefferson Parish*'s threshold requirements to trigger the per se rule. In other words, the tying arrangement must be the type of tie that could potentially harm competition in the tied-product market. . . . [T]hough the per se rule against tying doesn't require an exhaustive analysis into a tie's anticompetitive effects in the tied product market, the rule can be coherent only if tying is defined by reference to the economic effect of the arrangement."); Kaufman v. Time Warner, 836 F.3d 137, 141 (2d Cir. 2016) (requiring "anticompetitive effects in the tied market"); Wells Real Est., Inc. v. Greater Lowell Bd. of Realtors, 850 F.2d 803, 815 & n.11 (1st Cir. 1988) ("The tying claim must fail absent any proof of anti-competitive effects in the market for the tied product" and stating: "This is not to say that a plaintiff necessarily must prove the actual scope of anti-competitive effects in the market—the per se rule eliminates such a requirement. But the plaintiff must make some minimal showing of real or potential foreclosed commerce caused by the tie, if only as a matter of practical inferential common sense."); Amey, Inc. v. Gulf Abstract & Title, Inc., 758 F.2d 1486, 1503 (11th Cir. 1985) (requiring "anticompetitive effects in the tied market") *with* Suture Express, Inc. v. Owens & Minor Distribution, Inc., 851 F.3d 1029, 1037 (10th Cir. 2017) ("The four elements of a per se tying violation are: (1) two separate products are involved; (2) the sale or agreement to sell one product is conditioned on the purchase of the other; (3) the seller has sufficient economic power in the tying product market to enable it to restrain trade in the tied product market; and (4) a "not insubstantial" amount of interstate commerce in the tied product is affected."). *See also* Reifert v. S. Cent. Wisconsin MLS Corp., 450 F.3d 312, 317 (7th Cir. 2006) (stating the elements of a *per se* claim without listing anticompetitive effects in the tied market, but quoting with approval language from *Wells Real Estate* including "The tying claim must fail absent any proof of anti-competitive effects in the market for the tied product.").

[459] *See*, *e.g.*, Jefferson Parish Hosp. Dist. No 2 v. Hyde, 466 U.S. 2, 9–18 (1984); In re: Cox Enterprises, Inc., 871 F.3d 1093, 1098 (10th Cir. 2017); Wells Real Est., Inc. v. Greater Lowell Bd. of Realtors, 850 F.2d 803, 815 (1st Cir. 1988); Coniglio v. Highwood Servs., Inc., 495 F.2d 1286, 1291 (2d Cir. 1974); Driskill v. Dallas Cowboys Football Club, Inc., 498 F.2d 321, 323 (5th Cir. 1974). *See also* Illinois Tool Works Inc. v. Independent Ink, Inc., 547 U.S. 28, 46 (2006) (market power).

software markets and the fact that "simplistic application of per se tying rules carries a serious risk of harm."[460] The *Microsoft* court explained its thinking in the following terms, when analyzing the integration of an internet browser into an operating system and the allegation that this constituted an unlawful "technological tie":

> There is no doubt that it is far too late in the history of our antitrust jurisprudence to question the proposition that *certain* tying arrangements pose an unacceptable risk of stifling competition and therefore are unreasonable per se. But there are strong reasons to doubt that the integration of additional software functionality into [a computer operating system] falls among these arrangements. Applying *per se* analysis to such an amalgamation creates undue risks of error and of deterring welfare-enhancing innovation.
>
> The Supreme Court has warned that it is only after considerable experience with certain business relationships that courts classify them as per se violations. Yet the sort of tying arrangement attacked here is unlike any the Supreme Court has considered. . . .
>
> In none of these cases was the tied good physically and technologically integrated with the tying good. Nor did the defendants ever argue that their tie improved the value of the tying product to users and to makers of complementary goods. In those cases where the defendant claimed that use of the tied good made the tying good more valuable to users, the Court ruled that the same result could be achieved via quality standards for substitutes of the tied good. Here Microsoft argues that [Internet Explorer ("IE") and [the Windows operating system] are an integrated physical product and that the bundling of IE [technologies] with Windows makes the latter a better applications platform for third-party software. It is unclear how the benefits from IE [technologies] could be achieved by quality standards for different browser manufacturers. We do not pass judgment on Microsoft's claims regarding the benefits from integration of its [technologies]. We merely note that these and other novel, purported efficiencies suggest that judicial experience provides little basis for believing that, because of their pernicious effect on competition and lack of any redeeming virtue, a software firm's decisions to sell multiple functionalities as a package should be conclusively presumed to be unreasonable and therefore illegal without elaborate inquiry as to the precise harm they have caused or the business excuse for their use.[461]

The Supreme Court has also hinted on more than one occasion at its support for assessing procompetitive benefits when evaluating the legality of tying arrangements.[462] The Supreme Court has also explicitly noted that, if a *per se* claim cannot be established, a plaintiff has the option of attempting to plead and prove a case under the rule of reason.[463] In light of all this, it may not surprise you to learn that courts have resorted to a range of devices to avoid holding that *per se* condemnation is warranted in an individual tying case.[464]

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[460] United States v. Microsoft Corp., 253 F.3d 34, 84 (D.C. Cir. 2001) (en banc).

[461] *See* United States v. Microsoft Corp., 253 F.3d 34, 90–91 (D.C. Cir. 2001) (en banc). *See also id.* at 95 ("Because [Microsoft's argument about the benefits of technological tying] applies with distinct force when the tying product is platform software, we have no present basis for finding the per se rule inapplicable to software markets generally. Nor should we be interpreted as setting a precedent for switching to the rule of reason every time a court identifies an efficiency justification for a tying arrangement. Our reading of the record suggests merely that integration of new functionality into platform software is a common practice and that wooden application of *per se* rules in this litigation may cast a cloud over platform innovation in the market for PCs, network computers and information appliances.").

[462] *See* Nat'l Collegiate Athletic Ass'n v. Bd. of Regents of Univ. of Oklahoma, 468 U.S. 85, 104 n.26 (1984) ([T]ying may have procompetitive justifications that make it inappropriate to condemn without considerable market analysis."); Eastman Kodak Co. v. Image Tech. Servs., Inc., 504 U.S. 451, 478–79 (1992) ("It is undisputed that competition is enhanced when a firm is able to offer various marketing options, including bundling of support and maintenance service with the sale of equipment. *Nor do such actions run afoul of the antitrust laws. . . .*") (emphasis added).

[463] Jefferson Parish Hosp. Dist. No. 2 v. Hyde, 466 U.S. 2, 29 (1984) ("In order to prevail in the absence of per se liability, respondent has the burden of proving that the [tying] contract violated the Sherman Act because it unreasonably restrained competition. That burden necessarily involves an inquiry into the actual effect of the exclusive contract on competition among anesthesiologists.").

[464] *See*, *e.g.*, Suture Exp., Inc. v. Cardinal Health 200, LLC, 963 F. Supp. 2d 1212, 1220 (D. Kan. 2013) (declining to apply *per se* rule because, among other things, the tie in question involved "vertical arrangements, and [are] therefore less likely to be a per se violation"—what tie does not involve a vertical arrangement?—and because market power allegations were insufficient to support *per se* liability, although apparently they were not insufficient to support a rule-of-reason analysis). *See also* Illinois Tool Works Inc. v. Independent Ink, Inc., 547 U.S. 28, 35 (2006) ("Over the years . . . this Court's strong disapproval of tying arrangements has substantially diminished.").

In sum: the "*per se* rule against tying" actually amounts to something very much like the rule of reason, and it is not obvious why it is helpful to preserve the illusion of a real difference at the cost of wasted energy in pleading and adjudication.

The leading modern tying case is *Jefferson Parish*. The case dealt with a tie between healthcare services provided at a Louisiana hospital and anesthesiology services provided by a firm in a special relationship with the hospital. Justice O'Connor's concurrence in the judgment, for herself and three other members of the Court—which sets out criteria for the analysis of a tying claim under the rule of reason and proposes a candid recognition that the *per se* rule has been abandoned—has been at least as influential as Justice Stevens' opinion for the Court, which refused to abandon at least the rhetoric of *per se* illegality but indicated that special preconditions would govern the rule's application in tying cases. (Note, among other things, the different "separate product" tests: compare paragraphs 9–10 of the extract (majority test) with paragraphs 21–22 (concurrence test). What's the difference?)

Jefferson Parish Hospital Dist. No. 2 v. Hyde

466 U.S. 2 (1984)

Justice Stevens.

[1] We must decide whether the [contract challenged in this case] gives rise to a per se violation of § 1 of the Sherman Act because every patient undergoing surgery at the [East Jefferson Hospital] must use the services of one firm of anesthesiologists [Roux and Associates], and, if not, whether the contract is nevertheless illegal because it unreasonably restrains competition among anesthesiologists. [. . .]

[2] It is far too late in the history of our antitrust jurisprudence to question the proposition that certain tying arrangements pose an unacceptable risk of stifling competition and therefore are unreasonable "per se." The rule was first enunciated in *International Salt Co. v. United States*, 332 U.S. 392, 396 (1947), and has been endorsed by this Court many times since. The rule also reflects congressional policies underlying the antitrust laws. In enacting § 3 of the Clayton Act, 15 U.S.C. § 14, Congress expressed great concern about the anticompetitive character of tying arrangements. While this case does not arise under the Clayton Act, the congressional finding made therein concerning the competitive consequences of tying is illuminating, and must be respected.

[3] It is clear, however, that every refusal to sell two products separately cannot be said to restrain competition. If each of the products may be purchased separately in a competitive market, one seller's decision to sell the two in a single package imposes no unreasonable restraint on either market, particularly if competing suppliers are free to sell either the entire package or its several parts. For example, we have written that if one of a dozen food stores in a community were to refuse to sell flour unless the buyer also took sugar it would hardly tend to restrain competition if its competitors were ready and able to sell flour by itself. Buyers often find package sales attractive; a seller's decision to offer such packages can merely be an attempt to compete effectively—conduct that is entirely consistent with the Sherman Act.

[4] Our cases have concluded that the essential characteristic of an invalid tying arrangement lies in the seller's exploitation of its control over the tying product to force the buyer into the purchase of a tied product that the buyer either did not want at all, or might have preferred to purchase elsewhere on different terms. When such "forcing" is present, competition on the merits in the market for the tied item is restrained and the Sherman Act is violated. [. . .]

[5] Accordingly, we have condemned tying arrangements when the seller has some special ability—usually called "market power"—to force a purchaser to do something that he would not do in a competitive market. [. . .]

[6] *Per se* condemnation—condemnation without inquiry into actual market conditions—is only appropriate if the existence of forcing is probable. Thus, application of the *per se* rule focuses on the probability of anticompetitive consequences. Of course, as a threshold matter there must be a substantial potential for impact on competition in order to justify *per se* condemnation. If only a single purchaser were "forced" with respect to the purchase of a tied item, the resultant impact on competition would not be sufficient to warrant the concern of antitrust law. It is for this reason that we have refused to condemn tying arrangements unless a substantial volume of commerce is

foreclosed thereby. Similarly, when a purchaser is "forced" to buy a product he would not have otherwise bought even from another seller in the tied product market, there can be no adverse impact on competition because no portion of the market which would otherwise have been available to other sellers has been foreclosed. [. . .]

[7] When . . . the seller does not have either the degree or the kind of market power that enables him to force customers to purchase a second, unwanted product in order to obtain the tying product, an antitrust violation can be established only by evidence of an unreasonable restraint on competition in the relevant market. [. . .]

[8] . . . [A] tying arrangement cannot exist unless two separate product markets have been linked.

[9] The requirement that two distinguishable product markets be involved follows from the underlying rationale of the rule against tying. The definitional question depends on whether the arrangement may have the type of competitive consequences addressed by the rule. The answer to the question whether petitioners have utilized a tying arrangement must be based on whether there is a possibility that the economic effect of the arrangement is that condemned by the rule against tying—that petitioners have foreclosed competition on the merits in a product market distinct from the market for the tying item. Thus, in this case no tying arrangement can exist unless there is a sufficient demand for the purchase of anesthesiological services separate from hospital services to identify a distinct product market in which it is efficient to offer anesthesiological services separately from hospital services.

[10] Unquestionably, the anesthesiological component of the package offered by the hospital could be provided separately and could be selected either by the individual patient or by one of the patient's doctors if the hospital did not insist on including anesthesiological services in the package it offers to its customers. As a matter of actual practice, anesthesiological services are billed separately from the hospital services petitioners provide. There was ample and uncontroverted testimony that patients or surgeons often request specific anesthesiologists to come to a hospital and provide anesthesia, and that the choice of an individual anesthesiologist separate from the choice of a hospital is particularly frequent in respondent's specialty, obstetric anesthesiology. The District Court found that the provision of anesthesia services is a medical service separate from the other services provided by the hospital. The Court of Appeals agreed with this finding, and went on to observe that an anesthesiologist is normally selected by the surgeon, rather than the patient, based on familiarity gained through a working relationship. Obviously, the surgeons who practice at East Jefferson Hospital do not gain familiarity with any anesthesiologists other than Roux and Associates. The record amply supports the conclusion that consumers differentiate between anesthesiological services and the other hospital services provided by petitioners. [. . .]

[11] The question remains whether this arrangement involves the use of market power to force patients to buy services they would not otherwise purchase. Respondent's only basis for invoking the per se rule against tying and thereby avoiding analysis of actual market conditions is by relying on the preference of persons residing in Jefferson Parish to go to East Jefferson, the closest hospital. A preference of this kind, however, is not necessarily probative of significant market power.

[12] Seventy per cent of the patients residing in Jefferson Parish enter hospitals other than East Jefferson. Thus East Jefferson's "dominance" over persons residing in Jefferson Parish is far from overwhelming. The fact that a substantial majority of the parish's residents elect not to enter East Jefferson means that the geographic data does not establish the kind of dominant market position that obviates the need for further inquiry into actual competitive conditions. The Court of Appeals acknowledged as much; it recognized that East Jefferson's market share alone was insufficient as a basis to infer market power, and buttressed its conclusion by relying on "market imperfections" that permit petitioners to charge noncompetitive prices for hospital services: the prevalence of third party payment for health care costs reduces price competition, and a lack of adequate information renders consumers unable to evaluate the quality of the medical care provided by competing hospitals. While these factors may generate "market power" in some abstract sense, they do not generate the kind of market power that justifies condemnation of tying. [. . .]

[13] The record therefore does not provide a basis for applying the per se rule against tying to this arrangement. [. . .]

[14] In order to prevail in the absence of per se liability, respondent has the burden of proving that the [relevant] contract violated the Sherman Act because it unreasonably restrained competition. That burden necessarily

involves an inquiry into the actual effect of the exclusive contract on competition among anesthesiologists. This competition takes place in a market that has not been defined. The market is not necessarily the same as the market in which hospitals compete in offering services to patients; it may encompass competition among anesthesiologists for exclusive contracts such as the . . . contract [at issue in this case] and might be statewide or merely local. There is, however, insufficient evidence in this record to provide a basis for finding that the [present] contract, as it actually operates in the market, has unreasonably restrained competition. The record sheds little light on how this arrangement affected consumer demand for separate arrangements with a specific anesthesiologist. The evidence indicates that some surgeons and patients preferred respondent's services to those of [the anesthesiologist designated by the hospital], but there is no evidence that any patient who was sophisticated enough to know the difference between two anesthesiologists was not also able to go to a hospital that would provide him with the anesthesiologist of his choice.

Justice O'Connor, with whom Chief Justice Burger, Justice Powell, and Justice Rehnquist join, concurring in the judgment.

[15] Some of our earlier cases did indeed declare that tying arrangements serve hardly any purpose beyond the suppression of competition. However, this declaration was not taken literally even by the cases that purported to rely upon it. In practice, a tie has been illegal only if the seller is shown to have sufficient economic power with respect to the tying product to appreciably restrain free competition in the market for the tied product. Without control or dominance over the tying product, the seller could not use the tying product as an effectual weapon to pressure buyers into taking the tied item, so that any restraint of trade would be insignificant. The Court has never been willing to say of tying arrangements, as it has of price-fixing, division of markets and other agreements subject to per se analysis, that they are always illegal, without proof of market power or anticompetitive effect.

[16] The "per se" doctrine in tying cases has thus always required an elaborate inquiry into the economic effects of the tying arrangement. As a result, tying doctrine incurs the costs of a rule of reason approach without achieving its benefits: the doctrine calls for the extensive and time-consuming economic analysis characteristic of the rule of reason, but then may be interpreted to prohibit arrangements that economic analysis would show to be beneficial. Moreover, the per se label in the tying context has generated more confusion than coherent law because it appears to invite lower courts to omit the analysis of economic circumstances of the tie that has always been a necessary element of tying analysis.

[17] The time has therefore come to abandon the "per se" label and refocus the inquiry on the adverse economic effects, and the potential economic benefits, that the tie may have. The law of tie-ins will thus be brought into accord with the law applicable to all other allegedly anticompetitive economic arrangements, except those few horizontal or quasi-horizontal restraints that can be said to have no economic justification whatsoever. This change will rationalize rather than abandon tie-in doctrine as it is already applied. [. . .]

[18] Tying may be economically harmful primarily in the rare cases where power in the market for the tying product is used to create additional market power in the market for the tied product. The antitrust law is properly concerned with tying when, for example, the flour monopolist threatens to use its market power to acquire additional power in the sugar market, perhaps by driving out competing sellers of sugar, or by making it more difficult for new sellers to enter the sugar market. But such extension of market power is unlikely, or poses no threat of economic harm, unless the two markets in question and the nature of the two products tied satisfy three threshold criteria.

[19] First, the seller must have power in the tying product market. Absent such power tying cannot conceivably have any adverse impact in the tied-product market, and can be only pro-competitive in the tying product market. If the seller of flour has no market power over flour, it will gain none by insisting that its buyers take some sugar as well.

[20] Second, there must be a substantial threat that the tying seller will acquire market power in the tied-product market. No such threat exists if the tied-product market is occupied by many stable sellers who are not likely to be driven out by the tying, or if entry barriers in the tied product market are low. If, for example, there is an active and vibrant market for sugar—one with numerous sellers and buyers who do not deal in flour—the flour

monopolist's tying of sugar to flour need not be declared unlawful. If, on the other hand, the tying arrangement is likely to erect significant barriers to entry into the tied-product market, the tie remains suspect.

[21] Third, there must be a coherent economic basis for treating the tying and tied products as distinct. All but the simplest products can be broken down into two or more components that are "tied together" in the final sale. Unless it is to be illegal to sell cars with engines or cameras with lenses, this analysis must be guided by some limiting principle. For products to be treated as distinct, the tied product must, at a minimum, be one that some consumers might wish to purchase separately without also purchasing the tying product. When the tied product has no use other than in conjunction with the tying product, a seller of the tying product can acquire no additional market power by selling the two products together. If sugar is useless to consumers except when used with flour, the flour seller's market power is projected into the sugar market whether or not the two products are actually sold together; the flour seller can exploit what market power it has over flour with or without the tie. The flour seller will therefore have little incentive to monopolize the sugar market unless it can produce and distribute sugar more cheaply than other sugar sellers. And in this unusual case, where flour is monopolized and sugar is useful only when used with flour, consumers will suffer no further economic injury by the monopolization of the sugar market.

[22] Even when the tied product does have a use separate from the tying product, it makes little sense to label a package as two products without also considering the economic justifications for the sale of the package as a unit. When the economic advantages of joint packaging are substantial the package is not appropriately viewed as two products, and that should be the end of the tying inquiry. The lower courts largely have adopted this approach.

[23] These three conditions—market power in the tying product, a substantial threat of market power in the tied product, and a coherent economic basis for treating the products as distinct—are only threshold requirements. Under the rule of reason a tie-in may prove acceptable even when all three are met. Tie-ins may entail economic benefits as well as economic harms, and if the threshold requirements are met these benefits should enter the rule-of-reason balance. [. . .]

[24] The ultimate decision whether a tie-in is illegal under the antitrust laws should depend upon the demonstrated economic effects of the challenged agreement. It may, for example, be entirely innocuous that the seller exploits its control over the tying product to "force" the buyer to purchase the tied product. For when the seller exerts market power only in the tying product market, it makes no difference to him or his customers whether he exploits that power by raising the price of the tying product or by "forcing" customers to buy a tied product. On the other hand, tying may make the provision of packages of goods and services more efficient. A tie-in should be condemned only when its anticompetitive impact outweighs its contribution to efficiency.

* * *

In practice, the separate-products test can often be decisive, but it can be hard to apply: particularly in cases alleging that the technological integration of digital products and services constitutes an objectionable tie. This was the dispositive issue in the district court's analysis of Epic Games' challenge to Apple's requirement that apps distributed in the iOS App Store must use Apple's own In-App Payments ("IAP") solution.

CASENOTE: Epic Games, Inc. v. Apple Inc.

559 F. Supp. 3d 898 (N.D. Cal. 2021); 67 F.4th 946 (9th Cir. 2023)

One of the highest-profile tying cases of recent years involved a challenge by Epic Games, the developer of the blockbuster video game Fortnite, to some of the conditions imposed by Apple as a condition of participation in the iOS ecosystem. One claim involved the allegation that Apple's requirement that an app sold on iOS must use Apple's in-app payment ("IAP") system. Epic challenged this obligation as an unlawful tie in violation of Section 1: on this theory, the iOS app distribution platform was the tying product, and IAP was the tied product.

Judge Gonzales-Rogers began with a formulation of the *per se* rule against tying. "For a tying claim to suffer *per se* condemnation, a plaintiff must prove: (1) that the defendant tied together the sale of two distinct products or services; (2) that the defendant possesses enough economic power in the tying product market to coerce its customers into purchasing the tied product; and (3) that the tying arrangement affects a not insubstantial volume of commerce in the tied product market."

But the judge declined to decide whether the *per se* rule or the rule of reason should apply to Apple's alleged tie. "Epic Games' claim fails under either framework because a tying claim cannot be sustained where the alleged good is not a separate and distinct product. . . . [But] IAP is not a product." Instead, "IAP is but one component of the full suite of services offered by iOS and the App Store." It "is not bought or sold but it is integrated into the iOS devices." The court declined to disaggregate the two-side App Store platform into separate services "to create artificially two products," just as it would decline to disaggregate a car from the tires with which it was sold. The judge noted that Epic had not presented any evidence that "demand exists for IAP as a standalone product." To the contrary, the record showed that "[p]ayment processing is simply an input into the larger bundle of services provided by the IAP system. While there may be a market for payment processing, that fact is irrelevant as IAP is not just payment processing." As a result, "whether analyzed as an integrated functionality or from the perspective of consumer demand, IAP is not a separate product from iOS app distribution. Thus, Epic Games . . . fails to show the existence of an illegal tie under Section 1."

On appeal, the Ninth Circuit held that the district court had erred in concluding that there was no tie. The fact that Apple had chosen to integrate the products was not dispositive (given the "functional" analysis required by law). And "the App Store and IAP clearly can be separated[,] because Apple already does so in certain contexts, namely that IAP is not required for in-app purchases of physical goods." So the products *were* separate.

But the tie was not illegal. The Ninth Circuit followed the example set by the D.C. Circuit in *Microsoft* (see discussion above) in rejecting the application of the *per se* rule to ties involving software platforms. And under the rule of reason the IAP tie was "clearly lawful." Epic had failed to show that the procompetitive aims asserted by Apple—including Apple's own interest in receiving compensation for its intellectual property—could have been pursued in a realistic, less restrictive manner. "When evaluating proposed alternative means," the court warned, "courts must give wide berth to defendants' business judgments." As a result, Epic's Section 1 tying claim failed.

The Single Monopoly Profit Theorem

In cases and commentary dealing with tying and related practices, you will certainly encounter references to the "single monopoly profit theorem." This is the proposition that, under certain circumstances, only a fixed amount of profit can be extracted from a particular degree of market or monopoly power in a given market. As a result, when the theorem applies, certain practices that might be thought anticompetitive involving the use of market power in one market to increase market share in another market—like tying—do not increase the level of market power or the profits to be derived from it. In other words, there is only a "single monopoly profit" to be extracted—and in most circumstances it is probably already being extracted by the monopolist. And it follows that if a business is engaging in that practice, it must be profitable for other reasons than the generation of additional market power: as a result, a natural inference may be that it is profitable because it generates efficiencies.[465]

We can see the point more clearly with a somewhat simplified numerical example (which will ignore several complexities but illustrate the core principle). Suppose that there is a market for cups and a market for saucers. They are strict complements in fixed proportions: people only use cups with saucers, only use saucers with cups, and the ratio is always 1:1. Each cup and each saucer costs $1 to make and the monopoly price for each cup and saucer is $3. A monopolist in both markets would charge $6 for a cup+saucer set and make $4 of profit per set in

[465] Ward S. Bowman Jr., *Tying Arrangements and the Leverage Problem*, 67 Yale L.J. 19, 23 (1957) ("Where fixed proportions are involved, no revenue can be derived from setting a higher price for the tied product which could not have been made by setting the optimum price for the tying product. The imposition of a tie-in under these circumstances determines the identity of the seller, but the amount of the tied product actually sold will not differ at all from that which could be sold if the optimum price for the tying product were set. Another monopoly is not created. The seller has only established a new method of exercising his already existing monopoly in the regulated product. Leverage, therefore, does not exist when the proportions of the two products are fixed."); *see also* Aaron Director & Edward H. Levi, *Law and the Future: Trade Regulation*, 51 Nw. U. L. Rev. 281, 290 (1956).

total on, say, 1,000 set sales. (In other words, the revenue-maximizing price for a cup+saucer set is $6, of which $4 is profit.)

Suppose we make the saucer market perfectly competitive rather than monopolized. The price of saucers then goes down to the cost of $1 per saucer. But every saucer customer still needs one cup per saucer: a saucer alone is no good. The cup monopolist knows that demand is really for cup+saucer sets, and that the revenue-maximizing price for each set is $6. So the cup monopolist now charges $5 for each cup, of which $4 per cup is profit. The effective cup+saucer set price is now $6 (just as it was with a monopolist of both in the previous paragraph), and the total quantity sold of cups and saucers is just the same as it was with a single monopolist of both. And the cup monopolist makes the same profit ($4 per cup, 1,000 cups sold) as the monopolist in both cups and saucers would be making.

The point is that if underlying demand is for cup+saucer sets, then there is a fixed amount of maximum revenue, and thus of maximum profit, to be generated from monopoly sales of that set (a "single monopoly profit," if you will). A monopolist of any necessary component of that set can extract some amount up to that single monopoly profit: a monopolist of cups with a competitive saucer market cannot increase its profits any further by tying cups to saucers. So if we see that going on—the idea goes—it is probably because it is cheaper to supply them together or because there is a customer preference to buy them together. And those are *procompetitive* and proconsumer reasons to tie.

It is important to understand that the single monopoly profit theorem applies only when some restrictive criteria are met.[466] Among other things, it applies only when the products or services supplied in the two markets are strict complements consumed in fixed proportions (*e.g.*, one cup is always used with one saucer), and when the competitiveness of both markets are fixed. Let's look at some of the most important assumptions.

Assumption 1: strict complements consumed in fixed proportions. If the products are used in varying proportions by users depending on their price elasticity (*e.g.*, if more price-inelastic users purchase more games per console, or more razor blades per handle), then tying can help to measure usage and increase the monopolist's profits. In particular, shifting margin from the tying product (*e.g.*, games console or razor handle) to the tied product (*e.g.*, games or razor blades) can operate like second-degree price discrimination: less elastic users are charged a higher margin than more elastic ones, because they purchase more of the high-margin tied product.[467] In this case the tie may replicate an effect that the defendant could generate by engaging in price discrimination in the tying market alone. In other words, it would lead to an increase in profits. In light of the ambiguity of price discrimination, reasonable minds can disagree about whether the ability to extract surplus in this way through effective price discrimination should be seen as an efficiency, a harm, or a neutral consequence.

Separately, and importantly, if the products are not strict complements, such that there is some demand for the tied product without the tying product, the monopolist may generate additional profits by monopolizing the tied product market (*e.g.*, by driving rivals below viable scale through the tie).[468]

Assumption 2: tied market not vulnerable to competitive harm. If the market for the tied product is vulnerable to market power (*e.g.*, because costs decrease with scale), a tie could increase the monopolist's overall level of market power. For example, suppose that tying the monopolist's razor handles to razor blades would mean that rivals would be deprived of crucial scale economies and would not remain competitive. The result could be that they would exit from the market for blades and would face increased barriers to re-entry, leaving the

[466] *See generally* Einer Elhauge, *Tying, Bundled Discounts, and the Death of the Single Monopoly Profit Theory*, 123 Harv. L. Rev. 397 (2009).

[467] Ward S. Bowman Jr., *Tying Arrangements and the Leverage Problem*, 67 Yale L.J. 19, 23 (1957).

[468] Michael D. Whinston, *Tying, Foreclosure, and Exclusion*, 80 Am. Econ. Rev. 837, 850 (1990); Steven C. Salop, *Economic Analysis of Exclusionary Vertical Conduct: Where Chicago Has Overshot the Mark* in Robert Pitofsky (ed.) HOW THE CHICAGO SCHOOL OVERSHOT THE MARK: THE EFFECT OF CONSERVATIVE ECONOMIC ANALYSIS ON U.S. ANTITRUST (2008) ("Suppose, however, that some consumers do not buy the tying product and only buy the tied product. Those consumers would continue to benefit from tied-market competition. In contrast, if the monopolist engages in tying and drives out of the market all the independent producers of the tied product, then it would be in the position to exercise market power or even to monopolize the tying product. This anticompetitive theory requires an assumption that the tied-product market involves sufficient economies of scale that there would be an insufficient number of viable firms to maintain intense competition, if those firms were restricted to selling solely to consumers who purchased only the tied product market. Or, the number of competitors could fall to the point where tacit coordination is dangerously likely to succeed.").

monopolist with a second monopoly in blades in addition to the handle monopoly.[469] In turn, this may make entry against the integrated handle-blade monopolist harder than it would have been against the handle monopolist alone.

Assumption 3: tied market not an entry path to the tying market. If the market for the tied product is an important competitive on-ramp for entry into the tying market, a tie could increase the monopolist's overall level of market power by blocking the path. For example, suppose that it is generally difficult to enter the market for personal social networking services, because of powerful network effects (*i.e.*, a social network is more valuable when other people are already using the service). But suppose that one way in which it might be possible to enter such a market profitably is to build a large user base in an adjacent product or service, like mobile messaging services, and then to spin out additional social-networking features to those users. Under such circumstances, a monopolist of personal social networking might find it profitable to tie its social network to a mobile messaging app, to make it harder for a potential social networking competitor to use the messaging market as a staging ground to attack the networking monopoly.[470] Such a tie could increase the monopolist's overall pricing power by entrenching its social-network monopoly.[471] Likewise, if the tie may have the effect of requiring a would-be entrant into the tying market to also enter the tied market—that is, forcing "two-level entry"—it may serve to protect the monopoly in the tying market and thus increase market power. (A tie may also help the tier to evade rate regulation: can you see why?)

NOTES

1) Look back at the history of the law of resale price maintenance. Is it really "far too late in the history of our antitrust jurisprudence to question the proposition that certain tying arrangements pose an unacceptable risk of stifling competition and therefore are unreasonable 'per se'"? Why? How can we tell when it is too late to change a rule of antitrust doctrine?
2) Justice Stevens's opinion for the Court in *Jefferson Parish* appears to distinguish between "abstract" market power, on the one hand, and the kind of market power that matters for antitrust analysis of tying arrangements, on the other. What do you make of that distinction, in general and in light of the specific factors enumerated in the opinion?
3) What is the purpose of the separate products test?
4) In *Jefferson Parish* itself, the tied service was provided by a third party, not by the hospital that provided the tying service. Should this have affected the analysis?
5) Can you think of two or three tying practices, from the real world, that would satisfy the conditions for the single monopoly profit theorem to apply, and two or three that would not?
6) In cases where tying allows a defendant to measure inelasticity, and thus to permit a form of price discrimination, it may allow a defendant to extract the profits that it could otherwise able to reap by just setting discriminatory prices for the tying product. When this is true, is it correct that, as a result, the tying

[469] Barry Nalebuff, *Exclusionary Bundling*, 50 Antitrust Bull. 321, 325 (2005) ("If entry is costly, then rivals may not reappear after exiting, especially if they anticipate that the [defendant] can repeatedly drive them out via a costless cross-subsidy."); Einer Elhauge, *Tying, Bundled Discounts, and the Death of the Single Monopoly Profit Theory*, 123 Harv. L. Rev. 397, 413 (2009) ("If there are costs to entering the tied market, tying can profitably deter entry by an equally efficient rival by foreclosing enough of the tied market to make entry profits lower than entry costs. Likewise, if there are fixed costs to operating in the tied market, tying can cause equally efficient rivals in the tied market to exit (or deter their entry) and thus enable the tying firm to obtain a monopoly in the tied market. Other articles generalize the point to show that foreclosing a market can create anticompetitive effects by depriving rivals of network effects or economies of scale, scope, distribution, supply, research, or learning. If foreclosure decreases rival efficiency in any of those ways, it will worsen the market options available to buyers and lessen the constraint on the tying firm's market power in the tied market, thus enabling it to raise prices in the tied market even though rivals are not completely eliminated.").

[470] *See*, *e.g.*, First Amended Complaint, FTC v. Facebook, Inc., Case No. 1:20-cv-03590 (D.D.C. filed Aug. 19, 2021).

[471] Barry Nalebuff, *Exclusionary Bundling*, 50 Antitrust Bull. 321, 325 (2005) ("The elimination of B rivals may help protect the A monopoly. If potential entrants into the A market need a good B to make their package whole, they will now be at a disadvantage as the competitive complements market will have disappeared. It might also be possible that the A monopolist will gain power in the B market."); Steven C. Salop, *Economic Analysis of Exclusionary Vertical Conduct: Where Chicago Has Overshot the Mark* in Robert Pitofsky (ed.) HOW THE CHICAGO SCHOOL OVERSHOT THE MARK: THE EFFECT OF CONSERVATIVE ECONOMIC ANALYSIS ON U.S. ANTITRUST (2008) ("Suppose that [a] PC monopolist engages in tying of the media player and succeeds in monopolizing the media player as well. In this situation, entrants into PC operating systems would be forced to produce media player software too. In principle, this could raise barriers to entry into operating systems.").

practice is not harmful to competition: just allowing the defendant to extract the benefit of its existing and unchanged market power?

7) In the (in)famous *Windows Media Player* case, the European Commission prosecuted Microsoft for supplying Windows Media Player for free with Windows. It obtained a remedy requiring Microsoft to make an alternative version of Windows—"Windows N"—available without Windows Media Player, but permitted Microsoft to set the same price for that version. (Spoiler alert: it did not sell well.[472]) Was this a bad case for the Commission to have brought? A good case with a bad remedy? Or a good case with a good remedy?

F. Bundling

Bundling is closely related to tying. Like tying, it involves the application of a condition that allows market power in one market to be used to affect a second market. But, where tying requires the imposition of a requirement to purchase multiple products or services as a condition for buying one of them, bundling involves offering discounts for purchasing multiple different products or services together in a "bundle." In the paradigm case of bundling, a seller with market power in one product offers a discount on that product to customers that also buy another product or service from the seller. The core competitive concern is that the inability of unintegrated rivals—even equally or more efficient ones—to match the discounts may tend to support the creation or maintenance of market power in the second market.

For example, suppose that a company sells chemicals A, B, and C, each of which is in a separate market. The company is a monopolist of A and B, but the market for C is competitive. The company offers its customers a discount: any customer that buys A, B, *and* C together will get a discount of 20% on the bundle. Unintegrated rivals, which only offer C, may be unable to match that deep discount, even if they are more efficient producers of C: the integrated firm can make a profit on the overall bundle while the unintegrated firm cannot profitably set a price for C that would win customers.[473] As a result, the unintegrated suppliers of C may be deprived of minimum viable scale and may be forced to exit the market, leaving the company with a monopoly in all three products and the ability to charge monopoly prices.

It may be helpful to see this with a numerical example. Suppose that units of A, B, and C each cost $9 to make. The competitive price of each is $10; the monopoly price of each is $15. Without bundling, the monopolist will sell A and B for $15 (setting aside additional factors like Cournot complement pricing) and the monopolist and its unintegrated rivals will all sell C at $10. With bundling, the monopolist can offer a substantial discount on the bundle and still turn a profit: for example, it could offer a total discount of as much as $12 from the unbundled prices ($15+$15+$10 = $40; $40–$12 = $28), and still make $1 of profit on the bundle as a whole. But unintegrated rivals, selling only C, cannot compete with this, as they are making just $1 of profit on each unit of C. Customers will almost certainly prefer to pay $28 to buy the entire A+B+C bundle from the monopolist rather than pay full price for A and B (a total of $30) *and then* some amount more to buy C from an unintegrated rival. As a result, all else equal, the monopolist of A and B could comfortably offer a bundled discount sufficient to displace rivals' share in the market for C. If there are barriers to re-entering the market, the result could be that the monopolist of A and B acquires a third monopoly in C as well.

As with tying, there are many reasons why bundled discounts may be—and usually are—good rather than bad. All else equal, of course, low prices are great for consumers and for overall welfare. Bundled discounts may represent economies of scope (*i.e.*, supply-side cost savings arising from the simultaneous supply of different products or services), and/or (if the bundled products are complements) so-called Cournot complement pricing

[472] *See, e.g.*, Nicholas Economides & Ioannis Lianos, *A Critical Appraisal of Remedies In The E.U. Microsoft Cases*, 2 Colum. Bus. L. Rev. 346, 385 (2010) ("The two versions of Windows were sold in the E.U. at the same price and practically no OEM bought and adopted Windows-N. Thus, the remedy imposed by the Commission had no noticeable effect in the marketplace.").

[473] *See generally* Barry Nalebuff, *Exclusionary Bundling*, 50 Antitrust Bull. 321 (2005).

(the fact that the profit-maximizing pricing for two complementary products is lower than the total of the profit-maximizing prices for supplying each separately[474]).

And, as with tying, bundled pricing may result from an agreement between trading partners or from a unilateral conditional dealing policy of the seller: as such, bundles may be challenged under Section 1 or Section 2. But the leading cases—the Ninth Circuit's decision in *PeaceHealth* and the Third Circuit's decision in *LePage's*—establish a circuit split for the standard of legality. Both *PeaceHealth* and *LePage's* were decided under Section 2 alone. And unlike tying, bundling does not implicate a possible rule of *per se* illegality under Section 1.

As a result, Section 2 law is much more important to the analysis of bundling: so we will reserve our fuller discussion for Chapter VII.[475] We mention it here only to introduce the concept, and in light of bundling's close relationship with tying.

G. "Most Favored Nation" Agreements

A most favored nation agreement or clause—universally known as an "MFN" agreement—is a promise to treat a benefited party at least as well as that party's competitors. A simple MFN clause would provide, for example, that an input supplier will provide to its downstream customer inputs on terms no less favorable than the terms on which the input is available to the customer's rivals. It thus reassures the benefited party that competitors will not get a better deal from the bound party.

MFNs are complex creatures. On the one hand, they sound at first blush like a good and fair idea (nondiscriminatory treatment certainly sounds like a good idea), and they can support and promote competition, including by ensuring that the benefits of low prices or favorable terms are shared. On the other hand, however, MFNs can prevent trading partners, like input suppliers or distributors, from offering better terms to induce rivals to enter or expand in competition with incumbent monopolists, and they make it more expensive for the bound party to offer discounts (because such discounts must be shared with the beneficiaries of any MFNs). Thus, MFNs can be imposed by dominant firms to prevent rivals from making inroads by negotiating more favorable deals with input suppliers and distributors. When applied by a monopolist, an MFN may be challenged under Section 2 as well as, or instead of, Section 1.

MFNs can also be used by suppliers in oligopolistic markets to support and facilitate supracompetitive pricing by the participants in the oligopoly. Suppose that four participants in an oligopoly are currently enjoying the benefits of their legally independent but implicitly coordinated supracompetitive pricing, but they each fear that the others will cheat on the implicit terms of coordination by offering discounts. The public use of MFN clauses by each participant in dealings with customers can serve as a commitment mechanism, as it would make it more expensive for any one oligopolist to discount to any individual customer (because the MFN agreements would require that discount to be shared with all its customers, such that discounting would take a larger bite out of its profits). If all oligopolists introduce MFNs in parallel, supracompetitive pricing will be easier to maintain and the oligopoly will be more resilient.[476]

A variation of the MFN clause, called an "MFN-plus," provides that the trading partner will be treated *better* than its rivals: for example, such a clause might provide that the beneficiary will receive prices that are 10% lower than its competitors. These agreements, which effectively require trading partners to impose a surcharge on sales to rivals, generally pose much higher risks to competition and welfare.[477]

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[474] To see this intuitively, consider that an integrated seller of complements A and B considering whether to lower the price of complement A will not only be induced to do so the prospect of additional sales of A (which would be enjoyed by any unintegrated sellers of A), but also by the prospect of additional demand for complement B resulting from those additional sales. *See* Richard J. Gilbert & Michael L. Katz, *An Economist's Guide to* U.S. v. Microsoft, 15 J. Econ. Perspectives 25 (2001).

[475] *See infra* § VII.G.4.

[476] *See*, *e.g.*, Jonathan B. Baker & Judith A. Chevalier, *The Competitive Consequences of Most-Favored-Nation Provisions*, 27 Antitrust 20, 22–23 (Spring 2013).

[477] This appears to have been a primary target of the Robinson-Patman Act, contrary to the subsequent enforcement of that statute. For discussion, *see* Herbert Hovenkamp, THE ANTITRUST ENTERPRISE: PRINCIPLE AND EXECUTION (2005) 196.

CASENOTE: United States v. Apple, Inc.

791 F.3d 290 (2d Cir. 2015)

MFNs played a critical role in the *Apple* e-books case you will remember from Chapter V. As you may recall, in that case Apple facilitated a hub-and-spoke conspiracy to increase retail prices.

The scheme challenged in that case was, in part, a response to the fact that publishers had become dissatisfied with the pre-existing "wholesale" model of e-book sales through Amazon. Under that model, publishers sold e-books to Amazon at a wholesale price, which Amazon then sold to consumers at a retail price that Amazon independently determined. This retail price chosen by Amazon was often very low, even for the most desirable bestsellers. Publishers feared that these low retail prices would condition consumers to expect lower prices for e-books in future and erode the value of the value. But no individual publisher had the commercial clout to risk their e-books becoming unavailable on Amazon. Without the ability to coordinate directly among the publishers for joint negotiation—which of course would be a flagrant Section 1 violation—the publishers lacked an obvious way to change the status quo.

Along came Apple, a new entrant in e-book retail, with an idea. Apple would sell books on an "agency" model and remit 70% of the proceeds back to the publisher. The publisher, not Apple, would set the retail price: up to $14.99, $12.99, or $9.99 depending on the hardcopy price. The jewel in the crown of this plan was an MFN clause in Apple's agreement with each publisher. Each publisher would set an Apple price *no higher* than that e-book was selling elsewhere.

As the Second Circuit emphasized, the contribution of the MFN to the effectiveness of the scheme was profound. A publisher that signed and accepted such an obligation would have no commercially reasonable alternative to moving Amazon over to the same agency model set by Apple. If Amazon retained the ability to independently set low prices—prices that the publishers would then be forced by the MFN to apply to Apple sales as well—the consequences would be unsustainable. As a result, the MFN "played a pivotal role . . . by stiffening the spines of the publishers to ensure that they would demand new terms from Amazon, and protecting Apple from retail price competition." In effect, accepting the MFN amounted to accepting a penalty for continuing to tolerate Amazon's discounting: and, thus, a highly credible commitment to change it.

As we saw in Chapter V, Apple served as the intermediary to make sure that each publisher knew when other publishers signed up to the arrangement. In so doing, it helped establish a common understanding built on a shared commitment to end Amazon's discounting and move to a higher-priced model for e-book sales.

MFNs were again front and center in the DOJ's complaint in its suit against Blue Cross Blue Shield of Michigan, which was dismissed when Michigan banned health care provider MFNs by statute.[478]

Complaint, United States v. Blue Cross Blue Shield of Michigan

Case No. 2:10-cv-15155 (filed E.D. Mich. Oct. 18, 2010)

I. NATURE OF THIS ACTION

1. Blue Cross is by far the largest provider of commercial health insurance in Michigan and has been for many years. Blue Cross competes with for-profit and nonprofit health insurers. Blue Cross' commercial health insurance policies cover more than three million Michigan residents, more than 60% of the commercially insured population. Blue Cross insures more than nine times as many Michigan residents as its next largest commercial health insurance competitor. Blue Cross had revenues in excess of $10 billion in 2009. Blue Cross has market power in the sale of commercial health insurance in each of the relevant geographic markets alleged below.

[478] U.S. Dept. of Justice, Press Release, Justice Department Files Motion to Dismiss Antitrust Lawsuit Against Blue Cross Blue Shield of Michigan After Michigan Passes Law to Prohibit Health Insurers from Using [MFN] Clauses in Provider Contracts (Mar. 25, 2013).

2. Blue Cross is also the largest non-governmental purchaser of health care services, including hospital services, in Michigan. As part of its provision of health insurance, Blue Cross purchases hospital services on behalf of its insureds from all 131 general acute care hospitals in the state. Blue Cross purchased more than $4 billion in hospital services in 2007.

3. Over the past several years, Blue Cross has sought to include MFNs (sometimes called "most favored pricing," "most favored discount," or "parity" clauses) in many of its contracts with hospitals. Blue Cross currently has agreements containing MFNs or similar clauses with at least 70 of Michigan's 131 general acute care hospitals. These 70 hospitals operate more than 40% of Michigan's acute care hospital beds. Unless enjoined, Blue Cross is likely to enter into MFNs with additional Michigan hospitals.

4. Blue Cross generally enters into two types of MFNs, which require a hospital to provide hospital services to Blue Cross' competitors either at higher prices than Blue Cross pays or at prices no less than Blue Cross pays. Both types of MFNs inhibit competition:

> (A) "MFN-plus." Blue Cross' existing MFNs include agreements with 22 hospitals that require the hospital to charge some or all other commercial insurers more than the hospital charges Blue Cross, typically by a specified percentage differential. These hospitals include major hospitals and hospital systems, and all of the major hospitals in some communities. These 22 hospitals operate approximately 45% of Michigan's tertiary care hospital beds. (A tertiary care hospital provides a full range of basic and sophisticated diagnostic and treatment services, including many specialized services.) Blue Cross' MFN-plus clauses require that some hospitals charge Blue Cross' competitors as much as 40% more than they charge Blue Cross. Two hospital contracts with MFN-plus clauses also prohibit giving Blue Cross' competitors better discounts than they currently receive during the life of the Blue Cross contracts. Blue Cross' MFN-plus clauses guarantee that Blue Cross' competitors cannot obtain hospital services at prices comparable to the prices Blue Cross pays, which limits other health insurers' ability to compete with Blue Cross. Blue Cross has sought and, on most occasions, obtained MFN-plus clauses when hospitals have sought significant rate increases.
>
> (B) "Equal-to MFNs." Blue Cross has entered into agreements containing MFNs with more than 40 small, community hospitals, which typically are the only hospitals in their communities, requiring the hospitals to charge other commercial health insurers at least as much as they charge Blue Cross. Under these agreements, Blue Cross agreed to pay more to community hospitals, which Blue Cross refers to as "Peer Group 5" hospitals, raising Blue Cross' own costs and its customers' costs, in exchange for the equal-to MFN. A community hospital that declines to enter into these agreements would be paid approximately 16% less by Blue Cross than if it accepts the MFN. Blue Cross has also entered into equal-to MFNs with some larger hospitals.

5. Blue Cross has sought and obtained MFNs in many hospital contracts in exchange for increases in the prices it pays for the hospitals' services. In these instances, Blue Cross has purchased protection from competition by causing hospitals to raise the minimum prices they can charge to Blue Cross' competitors, but in doing so has also increased its own costs. Blue Cross has not sought or used MFNs to lower its own cost of obtaining hospital services.

6. Blue Cross' MFNs have caused many hospitals to (1) raise prices to Blue Cross' competitors by substantial amounts, or (2) demand prices that are too high to allow competitors to compete, effectively excluding them from the market. By denying Blue Cross' competitors access to competitive hospital contracts, the MFNs have deterred or prevented competitive entry and expansion in health insurance markets in Michigan, and likely increased prices for health insurance sold by Blue Cross and its competitors and prices for hospital services paid by insureds and self-insured employers[.] [. . .]

VI. BLUE CROSS' MFNs AND THEIR ANTICOMPETITIVE EFFECTS

A. The MFNs and their Terms

36. Since at least 2007, Blue Cross has sought to include MFNs or similar clauses in many of its agreements with Michigan hospitals. In some contracts, Blue Cross requires the hospital to contract with any other commercial

insurer at rates at least as high as the hospital contracts with Blue Cross - an equal-to MFN. In others, Blue Cross demands even more and requires the hospital to contract with other insurers at rates higher than those paid by Blue Cross, typically by a specified percentage differential - an MFN-plus. Some Blue Cross MFNs contain very limited exceptions, most notably an exception for commercial health insurers with a de minimis presence, as discussed in paragraph 47 below.

37. Blue Cross currently has MFNs in its contracts with more than half of Michigan's general acute care hospitals. Very few hospitals have refused Blue Cross' demands for an MFN. Other hospitals' contracts have not been renegotiated in recent years, but Blue Cross is likely to seek MFNs when its contracts with those hospitals come up for renegotiation, especially if the hospital requests a price increase.

38. Most of Blue Cross' MFNs require the hospital to "attest" or "certify" annually to Blue Cross that the hospital is complying with the MFN, and they often give Blue Cross the right to audit compliance. Insurers pay hospitals under different formulas . . . . These varying payment methodologies can cause uncertainty for a hospital comparing Blue Cross' effective payment rates with anticipated payment rates from different insurers. Therefore, a hospital seeking to avoid a payment reduction by Blue Cross - generally its largest commercial payer - sometimes contracts with Blue Cross' competitors at prices even higher than the MFN requires, to avoid being penalized if Blue Cross audits the hospital's compliance with the MFN.

39. Blue Cross' agreements with at least 22 Michigan hospitals contain MFN-plus clauses. These hospitals are among the most important providers of hospital services in their respective areas. . . .

40. In 2007, Blue Cross entered into a "Participating Hospital Agreement" ("PHA") containing an equal-to MFN with each of more than 40 hospitals it classifies as "Peer Group 5" hospitals: small, rural community hospitals, which are often the only hospital in their communities. Under that agreement, Blue Cross committed to pay more to those community hospitals that agreed to charge all other commercial insurers rates that would be at least as high as those paid by Blue Cross. Any community hospital that failed to attest compliance with the MFN would be penalized by payments from Blue Cross at least 16% less than if it complied with the MFN.

B. Anticompetitive Effects of Blue Cross' MFNs

41. Blue Cross' existing MFNs, and the additional MFNs that Blue Cross is likely to seek to include in future agreements with Michigan hospitals, have unreasonably lessened competition and are likely to continue to lessen competition by:

> a. Maintaining a significant differential between Blue Cross' hospital costs and its rivals' costs at important hospitals, which prevents those rivals from lowering their hospital costs and becoming more significant competitive constraints to Blue Cross;
>
> b. Raising hospital costs to Blue Cross' competitors, which likely reduces those competitors' ability to compete against Blue Cross;
>
> c. Establishing a price floor below which important hospitals would not be willing to sell hospital services to other commercial health insurers and thereby deterring cost competition among commercial health insurers;
>
> d. Raising the price floor for hospital services to all commercial health insurers and, as a result, likely raising the prices for commercial health insurance charged by Blue Cross and its competitors; and
>
> e. Limiting the ability of other health insurers to compete with Blue Cross by raising barriers to entry and expansion, discouraging entry, likely raising the price of commercial health insurance, and preserving Blue Cross' leading market position.

42. Blue Cross often receives substantially better discounts for hospital services than other commercial health insurers receive. Blue Cross knows that its discounts provide a competitive advantage against other health insurers. Blue Cross noted in April 2009 that its "medical cost advantage, delivered primarily through its facility [i.e.,

hospital] discounts, is its largest source of competitive advantage," and earlier stated that its advantages in hospital discounts "have been a major factor in its success in the marketplace."

43. In recent years, Blue Cross became concerned that competition from other insurers was eroding its hospital discount advantage - as it was. Blue Cross therefore sought to preserve its discount advantage by obtaining MFN-plus clauses, with the "expectation . . . that we would not have any slippage in our differential from what we experience today." In other words, rather than seeking lower prices from hospitals, Blue Cross negotiated MFN-plus clauses to maintain its discount differential and prevent potential competitors from obtaining hospital services at prices close to Blue Cross' prices and thereby becoming more significant competitive constraints on Blue Cross. During negotiations in 2008 with one hospital in Grand Rapids, Blue Cross wrote that "we need to make sure they [the hospital] get a price increase from Priority if we are going to increase their rates."

44. In most cases, Blue Cross obtained an MFN from a hospital by agreeing to increase its payments to the hospital. Blue Cross has sought and, on most occasions, obtained MFN-plus clauses when hospitals have sought significant rate increases. Blue Cross also agreed to increase rates to Peer Group 5 hospitals as part of the Peer Group 5 PHA, which included an equal-to MFN. Had a hospital not agreed to an MFN, Blue Cross likely would not have agreed to pay the higher rates sought by the hospital. Thus, the likely effect of the MFN has been to raise the prices of hospital services paid by both Blue Cross and its competitors, and by self-insured employers, and to increase health insurance prices charged by Blue Cross and its competitors.

45. Blue Cross' MFNs have resulted and are likely to continue to result in these anticompetitive effects in each of the relevant markets because they effectively create a large financial penalty for hospitals that do not accept them. Blue Cross patients are a significant portion of these hospitals' business, and Blue Cross patients typically are more profitable than Medicare and Medicaid patients, the hospitals' other most significant sources of business. A hospital that would otherwise contract with a competing insurer at lower prices than it charges Blue Cross would have to lower its prices to Blue Cross pursuant to the MFN if it sought to maintain or offer lower prices in contracts with other commercial insurers. The resulting financial penalty discourages a hospital with a Blue Cross MFN from lowering prices to health insurers competing with Blue Cross. Blue Cross' MFNs have caused hospitals to raise prices charged to other commercial health insurers, rather than lower prices to Blue Cross.

46. Prior to Blue Cross' obtaining MFNs, some hospitals gave greater discounts to some other commercial health insurers than they gave to Blue Cross. Without Blue Cross' MFNs, some hospitals had an incentive to offer lower prices to other insurers seeking to enter or expand in the hospital's service area and increase competition in the sale of commercial health insurance. [. . .]

48. Blue Cross' use of MFNs has caused anticompetitive effects in the markets for commercial health insurance in the geographic markets discussed below, among others. Hospitals in these markets have raised prices to some commercial health insurers, and declined to contract with other commercial health insurers at competitive prices. As a result, commercial health insurers that likely would have entered local markets to compete with Blue Cross have not done so, or have competed less effectively than they would have without the MFNs. Blue Cross' MFNs therefore have helped Blue Cross maintain its market power in those markets. The actual anticompetitive effects alleged below illustrate the types of competitive harm that have occurred and are likely to occur where Blue Cross obtains MFNs from hospitals throughout Michigan.

Steven C. Salop & Fiona Scott Morton, Developing an Administrable MFN Enforcement Policy

27 Antitrust 15 (2013)

[M]ost-favored-nation contractual provisions (MFNs) can lead to either procompetitive benefits or anticompetitive harms. MFNs can be procompetitive by enabling new products and thereby enhancing competition. For instance, MFNs can be used to prevent opportunism in situations where one of the parties makes relationship-specific investments in order to create a new product or improve an existing product or service. MFNs also can be used by a firm to deter rent-seeking delays and hold out problems in instances where important market information such as demand, value, or costs would be discovered after some contracts are signed. In these circumstances, the

MFN also may enable the parties to create or improve a product, where in its absence they would face too much risk and might choose not to. [. . .]

The anticompetitive effects of MFNs can be either collusive or exclusionary. MFNs can facilitate coordination or dampen oligopoly competition by making it impossible to offer selective discounts or prevent secret discounts. MFNs can soften price competition and thereby allow firms to charge higher prices than they otherwise would. These are harmful collusive effects. MFNs also can have exclusionary effects by raising the costs of rivals or entrants that attempt to compete by negotiating lower prices from suppliers of critical inputs, or by pioneering a different business model. [. . .]

[T]he following conditions suggest that MFNs are less likely to raise antitrust concerns:

- [a] Received only by smaller buyers: MFNs received only by small buyers comprising a small share of the market are likely to cause a smaller increase in seller price levels, perhaps additionally because the largest buyers may have sufficient bargaining power to prevent such price increases.
- [b] Provided to buyers (all of which are small) by smaller sellers that lack market power: MFNs offered by such sellers are unlikely to cause an increase in bargaining power or raise barriers to entry that would lead to consumer harm. Exceptions to this condition occur when a power buyer obtains MFNs from numerous small sellers or where the MFNs facilitate coordination among the small sellers.
- [c] Unconcentrated markets: Where neither the input market nor the output market are concentrated, coordination is less likely to be concern, even if there are MFNs. However, where only one of the markets is unconcentrated, the MFNs can raise barriers to entry or can facilitate coordination.
- [d] Input with close substitutes: Where inputs subject to MFNs have close substitutes, non-recipients can avoid being placed at a significant competitive disadvantage by purchasing a substitute input instead.
- [e] As part of long-term contract with locked-in or sunk assets: In this situation, MFNs may be a device for allocating cost and demand risk or for avoiding the potential for expropriation of efficient investment.
- [f] In exchange for significant investment, particularly by initial customer or technology sponsor: Providing an MFN can avoid delays and facilitate the launch of network effects by ensuring that an initial sponsoring buyer will not suffer a price disadvantage relative to other buyers that wait.
- [g] Input has uncertain value for innovative new product, with resulting potential for delays and holdout problems: Similar benefits of MFNs can occur when the value of the input is unclear and early buyers fear being locked into long-term contracts at prices that do not reflect market values.
- [h] As part of the settlement of one in a series a number of law suits brought against the provider: An MFN can be used to avoid holding out by plaintiffs hoping for a better settlement if they wait.

In contrast, the following conditions suggest that MFNs are more likely to raise competitive concerns, ceteris paribus. We do not intend these conditions to comprise irrebuttable presumptions. These concerns could well be offset by beneficial effects. Instead, these conditions suggest the need for further analysis of benefits and harms by counsel and the antitrust agencies:

- [a] Jointly adopted by horizontal agreement: Antitrust is generally suspicious of horizontal agreements involving price because they are more likely to have anticompetitive effects and are presumed less likely to be efficiency enhancing.
- [b] Provided by large sellers with market power: If a seller has market power, there is a greater concern that its MFN could have an anticompetitive purpose and effect.
- [c] Received by largest buyers: Similarly, if MFNs are received by the largest buyers, they are more likely to lead to higher prices paid by rivals than they are to generate lower prices paid by the buyers who receive the MFNs.
- [d] Multiple MFNs with high market coverage: The broader the coverage of MFNs, the more likely they are to have price effects downstream. This conclusion comes with the caveat, however, that highly efficient MFNs are more likely to gain large coverage.
- [e] Highly significant input: An MFN for an input that comprises just a trivial share of the buyers' cost is unlikely to generate substantial cost effects, whereas an MFN for a highly significant input can have that effect. Significant cost effects can both affect prices and impact entry and innovation.

- [f] Airtight MFN with audit rights and penalties for noncompliance: If an MFN is easily evaded by the seller granting it, it is less likely to constrain the seller's prices to other buyer and, therefore, less likely to have anticompetitive effects.
- [g] Retroactive MFN, perhaps with penalties: Retroactive MFNs can create larger disincentives for price discounts, particularly where there are penalties in addition to having to match the discounted price, thereby making price competition less likely.
- [h] MFN-plus provisions: MFN-plus provisions promise the recipient a strictly lower price than what is paid by rivals. As a result, even if the recipient pays a higher input price, the profits earned from its resulting cost-advantage may more than offset the adverse impact of the higher input price. This term is more likely lead to consumer harm.
- [i] Obtained by a leading buyer in response to new entry by a low cost, innovative competitor: This timing raises concerns that the purpose and likely effect of the MFN is to raise the cost and reduce the procompetitive impact of the new entrant.
- [j] Obtained by a leading buyer in exchange for an agreement by that buyer to deal exclusively with a leading seller: This timing and connection to an exclusive dealing agreement raises concerns that the MFN and exclusive dealing have the purpose and likely effect of raising barriers to competition at both levels of the market.
- [k] Only claimed rationale is that the buyer is more concerned about the price it pays relative to other competitors, not the absolute level of the price paid: A firm's competitive advantage and profits often are related more to the relative price it pays for inputs than the absolute price level. Where this occurs, a buyer may be willing to pay a higher input price in exchange for retaining a cost advantage, a condition that is more likely to lead to less price competition and consumer harm. Thus, it raises suspicions of anticompetitive purpose.
- [*l*] Only claimed rationale is that the largest buyer "deserves" the lowest price: The largest buyer sometimes (but not always) has the bargaining power to negotiate the lowest input price. But, entrants or smaller buyers sometimes have the ability to negotiate lower prices, and when they do, consumers may benefit from the increased competition. Where it occurs, the largest buyer's possibly greater bargaining power does not necessarily translate into consumer benefits or create an antitrust "right." Indeed, if the largest buyer would get the lowest price anyway, it does not need an MFN. This rationale might well be considered "non-cognizable" justification under the Sherman Act.

As noted above, this checklist is not intended to be a substitute for a full competitive effects analysis. That analysis would evaluate the likely benefits and harms from the implementation of MFNs in the particular market in order to predict the likely net effect on consumers. The impacts on price, quality, and innovation are the ultimate determinants of benefits and harms.

NOTES

1) Can you think of a good reason a firm might want an MFN-plus for procompetitive reasons? If not: should they be *per se* illegal? (Criminal, even?)
2) Suppose that a business with market power was willing to make investments in a trading partner (*e.g.*, to help them cover their costs or stay in business), but was worried about subsidizing competitors. Could an MFN help convince the business to make those investments?[479]
    a. Is the fear of "subsidizing competitors" unusual? Does contributing to the profitability of a trading partner *always* mean subsidizing rivals to some extent? Should a business be able to refuse to do so?
3) Do the competitive dangers of MFN provisions suggest that legislators and agencies should be cautious about creating nondiscrimination obligations? When might a statutory or regulatory nondiscrimination obligation be a desirable tool? When might it be harmful?
4) Would you advise a state or federal legislator to ban (some or all) MFNs? Under what circumstances? Take a shot at writing a statutory provision performing this function.

[479] *See*, *e.g.*, BCBS's Motion to Dismiss, United States v. BCBS of Michigan, Case No. 2:10-cv-14155, 2010 WL 5134814, *2 (E.D. Mich. filed Dec. 17, 2010) ("Blue Cross's MFNs help it fulfill its statutory obligations by ensuring that Blue Cross is not required to pay more than its fair share of hospital costs.").