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Vertical Practices and the Exclusion of Rivals Post *Eaton*

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I. INTRODUCTION

In the wake of the *ZF Meritor v. Eaton* decision, there is new uncertainty regarding the kinds of vertical contracting practices that will attract antitrust scrutiny under U.S. law.[2] In this case, the market share and loyalty rebates Eaton Corporation offered to truck manufacturers were found to violate antitrust law despite the fact that there was no evidence of pricing below cost. The court of appeals determined that the price-cost test, which, since *Matsushita v. Zenith* (1986) has been applied in cases in which predatory pricing is alleged, did not apply in *Eaton*. Elements of *Eaton*'s agreements had more in common with exclusive dealing than predatory pricing, the court said.[3]

Vertical agreements frequently include a variety of price and non-price restrictions, including market share and loyalty discounts, pre-specified sales territories, retail price restrictions (such as resale price maintenance), rebates, and product placement requirements. The *Eaton* decision, as well as several other recent cases involving exclusive dealing, illustrates the piecemeal fashion in which the courts have dealt with vertical agreements. It has been argued that decisions like *Eaton*, which move away from the broad application of the price-cost test, may discourage suppliers from offering non-predatory loyalty or market share discounts, as there may be no safe harbor, particularly when such discounts are part of a multidimensional vertical agreement.[4]

In this article we describe recent academic research that provides a coherent framework for the analysis of a host of vertical agreements with price or non-price restraints, thereby helping courts and economic experts to determine the potential exclusionary impact of these arrangements.[5] In truth, many vertical contracting practices share the same underlying economics: The vertical structure allows an upstream supplier and a downstream retailer to share industry profits gained through the supplier's increased market power. As a result, the retailer has an incentive to protect these profits by serving as a "gatekeeper," potentially limiting market

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[2] See *ZF Meritor, LLC v. Eaton Corp*., 696 F. 3d 254 (2012), referred to in the rest of this article as *Eaton*.

[3] In addition to market share discounts, the court of appeals also noted the length of the supply contracts, preferential pricing, product placement requirements, and purchase requirements. See *Eaton, supra* note 2 at 265-266.

[4] Daniel Crane et al., *Brief for Eighteen Scholars as Amici Curiae in Support of Petitioner*, (On Petition for Writ of Certiorari, in the matter of *Eaton v. ZF Meritor*), pp. 14-17 (March 28, 2013).

[5] Much of what follows is based on John Asker & Heski Bar-Isaac, *Raising Retailers' Profits: On Vertical Practices and the Exclusion of Rivals*, AMER. ECON. REV., forthcoming.

access by upstream rivals. If an upstream rival cannot access the market without some help from the gatekeeper, then vertical-contracting practices may result in exclusion.

Later in the article, we focus on potential anticompetitive aspects of vertical arrangements. We consider the choice between framing a case as predation or exclusive dealing and compare the economics of predatory pricing practices to those of exclusive deals within vertical agreements. We look more closely at exclusive-dealing settings and propose several screens for the detection of antitrust harm, regardless of whether the vertical practice involves price or non-price restraints.

And, finally, we weigh potential pro-competitive benefits of vertical agreements against the anticompetitive harm of exclusion in the specific context of resale price maintenance. In particular, we focus on one of the pro-competitive justifications for resale price maintenance raised in the majority judgment in *Leegin v. PSKS* (2007), the provision of retail services that may promote interbrand competition.[6]

II. ASSESSING THE EXCLUSIONARY IMPACT OF VERTICAL AGREEMENTS

A. Predation or Exclusive Dealing?

In the classic price-predation scenario, a firm forces the market price down to the point where a rival is forced to exit or otherwise accommodate the predator. In the predatory phase, both firms suffer from (and consumers benefit from) lower than usual prices, and consumers have ready access to both firms' products. Consumers may switch to a cheaper good, which causes harm to a rival. The predator is willing to reduce prices in this predatory phase only if it believes it can recoup any losses following a rival's exit from the market.

In contrast, exclusive dealing often involves agreements that align the incentives of a gatekeeper (say, a retailer) and a firm (most often a supplier) seeking to limit a rival's market access. Exclusive dealing allows one firm better access to the market than a rival may have, even if the rival is able to compete on price. To borrow an example from *Ortho v. Abbott* (1996), suppose Firm A supplies shampoo and conditioner to retailers and has market power in the conditioner market, while Firm B supplies only shampoo to retailers. Even if Firm B is an efficient producer of shampoo, it may not be able to compete if Firm A offers a discount on shampoo and conditioner when sold as a package.[7]

To the extent that suppliers can compete for exclusive retailers, antitrust harm from exclusive dealing can be mitigated. For this reason, in cases of exclusive dealing, it is important to distinguish between the ability to effectively compete in the market and the ability to effectively compete for a particular customer.[8] Under an exclusive dealing scenario, the incumbent firm continues to gain while the rival loses; no period of recoupment may be required.

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[6] *Leegin Creative Leather Products, Inc. v. PSKS, Inc.* 127 S.Ct. 2705 (2007) at 2717.

[7] *Ortho Diagnostic Systems, Inc. v. Abbott Laboratories, Inc.* 920 F. Supp. 455 (S.D.N.Y. 1996).

[8] *See* Einer Elhauge & Abraham L. Wickelgren, *Anti-Competitive Market Division Through Loyalty Discounts Without Buyer Commitment,* John M. Olin Center for Law, Economics, and Business, Discussion Paper No. 723 (August 1, 2012).

The vertical structure of an industry plays very different roles in the context of predatory pricing than it does in the context of exclusive dealing. In a predation setting, the vertical structure of the industry typically determines whether the conduct at issue resulted in harm. For example, in *Brooke Group v. Brown & Williamson* (1993), Brown & Williamson lowered generic cigarette prices below average variable cost in order to harm rival Liggett.[9] In this instance, cigarettes were sold to wholesalers; however, this fact was not essential to understanding the nature of the antitrust harm.

In an exclusive dealing setting, an upstream supplier typically forms an agreement (whether implicit or explicit) with a downstream gatekeeper that aligns the incentives of each party to limit competition. In *Eaton*, the relationship among Eaton, ZF Meritor, and the truck manufacturers—and an understanding of how the manufacturers sold to consumers—was central to the Court of Appeal's view of the various contractual mechanisms Eaton Corporation employed.

B. When are Payments to Gatekeepers a Problem?

Once a case has been identified as an exclusive dealing matter, the question becomes, is antitrust harm plausible? In general, the implementation of individual exclusive dealing arrangements varies from case to case, and in many instances, such as in *Eaton*, there are multiple dimensions to the arrangements that may prompt allegations of exclusion.

This variation is one reason for the piecemeal treatment of exclusive dealing in the courts. A unified framework that can accommodate both price and non-price elements of vertical agreements could be helpful in this context. Fortunately, the underlying economics is common to many vertical agreements, suggesting a unified framework may be within reach.

Many vertical practices, such as those listed above, allow retailers to capture a portion of the profit attributable to the upstream supplier's market power.[10] Indeed, it is precisely these shared profits (and the threat of losing them) that have been used to provide a pro-competitive theory of vertical contracting practices.[11] On the other hand, the gatekeeper understands that competition between manufacturers will reduce industry rents and, therefore, the profits transferred to the retailer, and may have incentives to exclude (or limit the entry of) a rival manufacturer in order to protect its share of profits.[12] If an entrant cannot establish itself without some help from the gatekeeper, the vertical conduct may result in exclusion.

A central question to ask is whether the entrant can offer a mutually beneficial agreement to the gatekeeper. Unless the entrant has a considerable cost advantage, the answer generally is

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

[10] Note that this framing can easily be flipped, so that a retailer incentivizes the supplier to exclude.

[11] Klein & Murphy (1988) argue that manufacturers can use these quasi-rents to entice retailers to provide the desired level of service. *See* Benjamin Klein & Kevin M. Murphy, *Vertical integration as a self-enforcing contractual arrangement*, 87(2) AMER. ECON. REV. 415-420 (1997).

[12] Comanor & Rey (2001) make a related point in the context of exclusive dealing. Similarly, Krattenmaker & Salop (1986) make references to a closely related mechanism in their discussion of the "Cartel Ringmaster" (pp. 238-240 and in footnote 71). *See* William S. Comanor & Patrick Rey, *Vertical Mergers and Market Foreclosure*, 21 RESEARCH IN L. & ECON. 445-458 (2004); Thomas G. Krattenmaker & Steven C. Salop, *Anticompetitive exclusion: raising rivals' costs to achieve power over price*, 96(2) YALE L.J. 209-293 (1986).

no. Competition diminishes the profits of both incumbent and entrant. So for a contract to be acceptable to the retailer, the entrant's post-entry profits must be sufficient to offset the profits from market power the incumbent can share with the gatekeeper.

To see how this may work, consider two simple examples.[13] In the first, a supplier offers a loyalty rebate to its retailers. This rebate is a non-contractual lump-sum payment each quarter to reward retailers that purchase a high share of the supplier's product. Implicit is the threat that, should a supplier entrant gain a sufficient foothold in the industry, these payments will disappear. In this instance, the loyalty rebate is the sharing of profits generated by the market power of the incumbent supplier; and the threat that meaningful entry will cause them to go away is made credible by the fact that entry will reduce the profits that the supplier has to share.

As a second example, consider a resale price maintenance ("RPM") scheme. Here, a supplier sets a minimum retail price above the competitive price level, dampening competition between retailers. As a result, the supplier also controls the margin that retailers enjoy, since the supplier also controls the wholesale price. In this example, the retailer's margin is the transfer of profits from suppliers to retailers—and retailers may have incentives to exclude rival suppliers in order to protect their margins.[14]

C. Potential Screens for Assessing Antitrust Harm

The screens described below are designed to address the central inquiry: Do the transfers between the incumbent and the gatekeeper have the potential to exclude the rival?[15]

- **Gatekeepers control market access:** For any exclusionary scheme to be successful within this framework, gatekeepers must be central to effective market access.[16]
- **Market power exists:** For a supplier to share rents with gatekeepers, the supplier must have market power. In the absence of market power it is difficult to see how supplier profits can be created and used to give a retailer the incentive to exclude a rival.[17]
- **Profits decrease with greater competition from rivals:** A supplier and a gatekeeper are willing to commit to a vertical agreement because of the increase in the profits to be shared under exclusion. If increased upstream competition does not lead to a decrease in shared profits, threats to withhold payments to gatekeepers are not credible. This feature of many vertical agreements makes it possible for a supplier to exclude a rival without resorting to predatory pricing, as had been alleged in *Eaton*.

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[13] We assume away any pro-competitive benefits in these hypothetical examples. For instance, it is well established that service dividends to consumers often accrue due to the sorts of arrangements we discuss here.

[14] This concern is expressed in *Leegin Creative Leather Products, Inc. v. PSKS, Inc*. 127 S.Ct. 2705 (2007) at 2717.

[15] Note that these screens do not include any consideration regarding who actually initiated the conduct. This is because the economics suggest both the supplier and the gatekeepers benefit, making the question irrelevant.

[16] If gatekeepers can be bypassed at a cost that is not prohibitive, then the framing of a retailer as the gatekeeper is not supported.

[17] Establishing market power in a relevant market is an accepted aspect of a case under Section 2 of the Sherman Act, but would also be important where this line of economics is to be used in a case brought under Section 1.

- **Retailer profits decrease with greater competition:** For aligned incentives across a gatekeeper and a supplier to restrict entry, gatekeepers would have to be worse off if entry occurred.

Examining the extent of transfers pre- and post-entry using the screens above would provide an initial assessment of the potential harm to competition. Of course, a rule of reason analysis would be unlikely to end at this point; it is well established in law and economics that a wide variety of price and non-price vertical constraints may have pro-competitive effects.[18] In the next section, we turn to a consideration of these efficiency justifications.

III. ANALYSIS WITH PRO-COMPETITIVE EFFECTS

A persistent challenge when determining liability in cases involving vertical arrangements is how to reconcile the pro-competitive and anticompetitive explanations for such arrangements. As an illustration, consider one such implication of RPM agreements: In *Leegin*, the Supreme Court recognized that such agreements could encourage non-price competition across retailers through increased service provision, which in turn could increase competition across brands.[19] On the other hand, the discussion in Section II suggests that service provision by retailers may be the very thing that makes exclusion feasible: An increase in retail service shifts demand outward, increasing industry profits and, as a result, the proportion of profits a supplier can share with a retailer through the vertical agreement.

The screens presented earlier in this article beg the question: Would the provision of service diminish in the absence of the RPM? If the answer is "yes," trading off the gains in service against the exclusionary effect of the conduct becomes somewhat similar to balancing efficiencies gained against market power increases in the context of mergers.[20] If total quantity increases when an RPM restraint is imposed, RPM provides a welfare gain through the increase in quantity and service provision. In the more likely event in which RPM leads to a decrease in quantity, the welfare gain due to the increase in service provision must be weighed against the welfare loss due to the decrease in quantity.[21] For consumers, increased satisfaction from service on the goods they do buy may offset higher prices and a reduction in goods consumed.

This trade-off is straightforward to describe in the abstract; resolving it in practice imposes a significant evidentiary burden on the defendant. For one, defendants may need to collect evidence that increased service provision is important enough to offset any exclusionary effects of RPM. For example, evidence regarding (i) the role of the retailers in the vertical structure (are they conduits, or do they add value?), (ii) whether service is mentioned or

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[18] In *Sylvania*, the Supreme Court recognized vertical constraints' effects on promoting interbrand competition. See *Continental T.V., Inc. v GTE Sylvania Inc.*, 433 US 36, 58–59 (1977). In the economics literature, *see* Lester G. Telser, *Why should manufacturers want fair trade?"* 3 J. L & ECON 86-105 (1960); Benjamin Klein & Kevin M. Murphy, *Vertical restraints as contract enforcement mechanisms*, 31(2) J. L & ECON 265-297 (1988); and Howard P. Marvel, *The Resale Price Maintenance Controversy: Beyond the Conventional Wisdom,* 63(1) ANTITRUST L.J. 59-92 (1994).

[19] *Leegin Creative Leather Products, Inc. v. PSKS, Inc.* 127 S.Ct. 2705 (2007) at 2714.

[20] Oliver Williamson, *Economics as an Anti-Trust Defense: The Welfare Trade-Offs*, 58(1) AMER. ECON. REV. (March 1968).

[21] When the excluded firm is more efficient, removing the RPM will also increase productive efficiency.

monitored in distribution contracts, and (iii) consumers' reactions to changes in service provision may provide information on the importance of service provision in the agreement. If service provision is an important part of the supplier–gatekeeper relationship, it is also likely to appear in the documents and business practices of the retailer. Information such as evidence of staffing allocated to service and service-specific training expenditures, as well as diaries of training days, may all be important parts of the record.

Of course, the precise implementation of an antitrust analysis will depend on the evidence at hand. However, the use of a framework such as the one we have presented here should assist economists in their collection and evaluation of the data associated with antitrust claims.