

EXCLUSIVE DEALING AS COMPETITION FOR DISTRIBUTION “ON THE MERITS”

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INTRODUCTION

The theory of “raising rivals’ costs” is a creative and original addition to our economic knowledge.¹ We now know that a firm may do something that raises its costs if it raises the costs of its rivals even more and results in an increase in its market power. However, the impact of this theoretical concept on antitrust enforcement has been limited, primarily because of the inherent difficulties in distinguishing “raising rivals’ costs” behavior from normal competitive conduct. As Judge Frank Easterbrook succinctly warns: “injuries to rivals are byproducts of vigorous competition.”² Consequently, “to deter aggressive conduct is to deter competition.”³ The Supreme Court similarly cautions that Section 2 of the Sherman Act should not be applied “against conduct which is competitive, even severely so, but against conduct which unfairly tends to destroy competition itself.”⁴

The essential antitrust issue is how to determine when aggressive competitive conduct that harms rivals destroys “competition itself.” Nearly everyone now agrees that a showing of consumer harm is a necessary condition for antitrust liability. The purpose of the antitrust laws is to protect consumers from producers, not producers from one another. However, some recent Section 2 decisions, most prominently *Microsoft*,⁵ appear to condemn conduct undertaken by a firm with market power solely because the conduct unjustifiably imposes a burden on competitors.⁶ Microsoft was

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¹ See Steven C. Salop & David T. Scheffman, *Raising Rivals’ Costs*, 73 AM. ECON. REV. 267 (1983); Thomas G. Krattenmaker & Steven C. Salop, *Anticompetitive Exclusion: Raising Rivals’ Costs to Achieve Power Over Price*, 96 YALE L. J. 209 (1986).

² *Ball Mem’l Hosp., Inc. v. Mutual Hosp. Ins., Inc.*, 784 F.2d 1325, 1338 (7th Cir. 1986).

³ *Id.*

⁴ *Spectrum Sports, Inc. v. McQuillan*, 506 U.S. 447, 458 (1993).

⁵ *United States v. Microsoft Corp.*, 87 F. Supp. 2d 30 (D.D.C. 2000), *rev’d in part, aff’d in part*, 253 F.3d 34 (D.C. Cir. 2001), *cert. denied*, 534 U.S. 952 (2001).

⁶ Eleanor M. Fox, *What Is Harm To Competition? Exclusionary Practices and Anticompetitive Effect*, 70 ANTITRUST L.J. 371 (2002), interprets *Microsoft* in this way.

found to have illegally used de facto exclusive contracts to control the two “most effective” distribution channels for browser—software—through computer manufacturers and Internet access providers. The Court concluded that these exclusive contracts did not involve “competition on the merits” because the contracts placed Netscape at a significant competitive disadvantage and lacked a legitimate efficiency rationale.⁷

This legal emphasis on the competitive process, specifically on whether a company’s behavior involves “competition on the merits,” is often a difficult burden for exclusive contracts to bear. A firm that pays distributors not to carry the products of its competitors would seem at least superficially not to be engaging in “competition on the merits.” The Court in *Microsoft* defines “competition on the merits” as conduct that produces “greater efficiency or enhanced consumer appeal.”⁸ Since the consumer benefits of exclusivity generally are not obvious, justifying an exclusive as “competition on the merits” requires a search for possible efficiencies. Exclusive distribution contracts, however, are frequently used in circumstances where the most commonly recognized economic efficiency of exclusives, the protection of manufacturer investments, does not fit the facts. The apparent lack of a legitimate business rationale then creates an unfortunate tendency to label exclusive distribution contracts as not involving “competition on the merits.”

This paper explains how exclusive distribution contracts often involve “competition on the merits.” The paper makes two main points. First, competition for distribution is shown to be an important part of the normal competitive process that benefits consumers. Although payments for distribution raise the cost to manufacturers of competing, competition among distributors will pass these payments on to consumers. Second, this competition for distribution is shown to often involve the use of exclusives because exclusivity efficiently facilitates contracting between manufacturers and distributors regarding the supply of distributor promotional efforts. In particular, exclusives assure manufacturers that they will receive the distributor promotion they pay for and maximize the return earned by distributors for their promotional efforts.

The economic analysis is applied to a number of major exclusive dealing cases, most importantly to *Standard Fashion*,⁹ where a dominant dress pattern manufacturer required its retailers to exclusively handle its patterns, and to the exclusive Internet access provider browser distribution contracts that were a key element of *Microsoft*. In both of these cases the manufacturers do not appear to have made any distributor investments that had to be

⁷ *Microsoft*, 253 F.3d at 58-59.

⁸ *Id.* at 59.

⁹ *Standard Fashion Co. v. Magrane-Houston Co.*, 258 U.S. 346 (1922).

protected by an exclusive. But the exclusive is shown to be a key aspect of competition for distribution “on the merits.”

Part I summarizes the potential anticompetitive effects of exclusive dealing and explains why both economics and antitrust law require anti-competitive exclusive contracts to cover a large share of distribution for a significant period of time. However, this is a necessary, not a sufficient, condition for an anticompetitive effect. The normal competitive process may lead a firm to win a large share of distribution.

Part II examines this competitive process in more detail and analyzes what it may mean for competition for distribution not to occur “on the merits.” Economic theories of predatory overpayment for distribution, as well as the possibility of underpayment for distribution, are analyzed and shown to have limited antitrust applicability. As a practical matter, the lack of “competition on the merits” refers not to the competitive process, but to the absence of a reasonable efficiency rationale for the adoption of exclusive contracts.

Part III, the heart of the paper, presents an expanded analysis of the economic efficiencies of exclusive distribution contracts. It describes why manufacturers often desire distributors to supply more promotion than they otherwise would; discusses the alternative contractual arrangements used by manufacturers to induce such increased distributor promotional efforts (with direct manufacturer investments in distributor promotional assets only one way in which this may be accomplished); and analyzes how each of these alternative, imperfect manufacturer compensation arrangements create an incentive for distributors to sell rival products that is prevented with exclusive dealing. Exclusive contracts facilitate contracting for distributor promotion by creating dedicated distributors who cannot easily “free-ride” on the manufacturer’s promotion compensation arrangement by switching their promotional efforts to the sale of rival brands. Exclusive contracts also maximize the returns received by distributors for promotion by permitting distributors to broker all their customers as a group to a single manufacturer. This analysis demonstrates how exclusives frequently are a procompetitive element of distribution contracts that enhance consumer welfare.

I. THE POTENTIAL ANTICOMPETITIVE EFFECTS OF EXCLUSIVE DEALING

A. *Anticompetitive Exclusive Dealing Requires Substantial Foreclosure*

Assume for simplicity that the sale of a product involves two stages, manufacturing and distribution. A manufacturer sells its product to a distributor, who then sells it to final consumers. The distributor may be a final retailer or a supplier of another product that includes the manufacturer's product. For example, Microsoft and Netscape are manufacturers of browser software who distribute their products (Internet Explorer and Navigator browser software, respectively), in part, through computer manufacturers and Internet access providers.

Anticompetitive exclusive dealing requires foreclosure of a sufficient share of distribution so that a manufacturer's rivals are forced to operate at a significant cost disadvantage for a significant period of time. In particular, if exclusive contracts foreclose a sufficient share of distribution to rivals for a significant time so that what remains to serve competitors cannot support a manufacturer of minimum efficient scale, the exclusive will force existing competitors and potential new entrants to operate at a cost disadvantage. The exclusives then may have the effect of driving out and/or preventing entry of manufacturing competitors until sufficient distribution becomes available.

If there is easy entry into distribution, it will be extremely difficult for a manufacturer to foreclose distribution to its rivals with exclusives. For example, consider an automobile manufacturer that distributes its product through exclusive retail dealers. If the supply of dealer services is highly elastic, the exclusives cannot cut off distribution to the manufacturer's actual or potential rivals. If all automobile manufacturers use exclusive dealing arrangements, a new entrant in automobile manufacturing would have to arrange for independent distribution. However, dealers can be obtained for a new automobile brand, such as Lexus, either by contracting with existing dealers (to switch their dealerships at contract expiration to the new brand or to open new additional dealerships) or by contracting with new dealers. The highly elastic supply of distributors makes it unlikely that exclusive dealing arrangements could significantly deter entry.¹⁰

¹⁰ An alternative anticompetitive theory operates not by creating a cost disadvantage that drives out or prevents the entry of efficient manufacturing competitors, but by driving out competing suppliers of distribution services. The dominant manufacturer then uses its control over distribution to collect a monopoly price on providing distribution of other manufacturers' products. See Michael D. Whinston, *Tying, Foreclosure, and Exclusion*, 80 AM. ECON. REV. 837 (1990). This alternative anticompetitive

In contrast to the automobile case, where dealers distribute only one type of product, a manufacturer's product may be distributed by multi-product distributors, such as grocery stores. In these cases, the manufacturer's product may be a relatively small part of a distributor's total sales. Therefore, although there may be free entry into distribution, it may not be economical for manufacturers to provide their own distribution or for new distributors to enter to serve manufacturing rivals. In these cases, competing manufacturers must contract for distribution with existing distributors.

In order for an exclusive to create or maintain manufacturer market power under these circumstances, a number of conditions must be present. A useful way to think about these conditions required for anticompetitive exclusion is to consider the exclusive dealing contract as a conspiracy among distributors organized by a dominant manufacturer. The anticompetitive goal is to monopolize distribution, or to monopolize the entire industry (manufacturing and distribution) by monopolizing distribution. The colluding distributors and dominant manufacturer then jointly share the industry monopoly profits. The economic conditions required for successful anticompetitive exclusion revolve around the incentives of individual distributors to remain outside the exclusive dealing cartel.

The incentives to remain outside of a cartel, present in all conspiracies, make it particularly difficult to achieve anticompetitive exclusion by organizing a conspiracy among many small distributors when there are limited economies of scale in manufacturing. Under these circumstances, each individual distributor has more to gain by contracting with a competing manufacturer rather than entering the exclusive dealing arrangement. Since competitive manufacturers can survive at a small scale, a competitive manufacturer needs at most a few distributors. Therefore, a dominant manufacturer must contract on an exclusive basis with essentially all dis-

mechanism cannot operate in the examples of exclusive dealing contracts discussed in this paper because distributors that commit to an exclusive do not sell distribution services to competing manufacturers. This alternative anticompetitive mechanism also is unlikely to operate because of the absence of economies of scale in the supply of distribution services and, therefore, the difficulty of driving out all competing distributors. Alternatively, distributors may face economies of scope, for example, if they cannot survive without distributing the dominant manufacturer's brand. This argument was recently presented by the U.S. Department of Justice, but rejected by the court, in *United States v. Dentsply Int'l, Inc.*, 277 F. Supp. 2d 387 (D. Del. 2003). Why a manufacturer of such an essential product would collect its economic return by demanding an exclusive and monopolizing distribution, rather than merely increasing the price of its product, is discussed in Dennis W. Carlton & Michael Waldman, *The Strategic Use of Tying to Preserve and Create Market Power in Evolving Industries*, 33 RAND J. OF ECON. 194 (2002), where the exclusive is assumed to protect the manufacturer's market power into the future; see also Dennis W. Carlton, *A General Analysis of Exclusionary Conduct and Refusal to Deal: Why Aspen and Kodak are Misguided*, 68 ANTITRUST L.J. 659 (2001).

tributors in order to block competitors and attain market power. However, a dominant manufacturer could not pay every distributor enough to join such an exclusive dealing cartel. Even if the dominant manufacturer transferred all the collusive industry profit to distributors, it would still pay individual distributors to remain outside the cartel. Each distributor would find it more profitable to contract with a competing manufacturer and expand its sales at the expense of the other colluding distributors.

If there are economies of scale in distribution, so that there are only a few distributors, it may be possible to get all distributors to agree not to deal with rival manufacturers. This is analogous to what occurred in *Standard Oil*,¹¹ a case that involved de facto exclusive dealing agreements at the turn of the century between the three railroads transporting petroleum products and the dominant refiner, Standard Oil.¹² In terms of our framework, the railroads can be thought of as distributors and Standard Oil as the dominant manufacturer. Standard Oil and the railroads placed Standard's refining rivals at a disadvantage by jointly agreeing to deal with non-Standard refiners only at unfavorable list-price terms.¹³ However, although there were only three railroads that could transport petroleum products,¹⁴ the railroads could not take advantage of the large economies of scale and difficulty of new entry into distribution to establish an effective collusive rate-setting agreement. Their attempted collusive agreements continually broke down because individual railroads always found it in their interests to cheat on the collusive rates by offering discounts to shippers, who needed to contract with only one railroad to remain in business. A successful railroad cartel was not established until Standard Oil was brought into the collusive arrangement as a cartel policer, acting as an "evener" of oil shipments to enforce collusively agreed upon individual railroad market shares.¹⁵

¹¹ *Standard Oil Co. of N.J. v. United States*, 221 U.S. 1 (1911).

¹² See Elizabeth Granitz & Benjamin Klein, *Monopolization by "Raising Rivals' Costs": The Standard Oil Case*, 39 J.L. & ECON. 1 (1996).

¹³ An outright agreement not to deal with any refiner other than Standard Oil would have violated the railroads' common carrier status.

¹⁴ Granitz & Klein, *Monopolization by "Raising Rivals' Costs": The Standard Oil Case*, *supra* note 12 at 3-9.

¹⁵ *Standard Oil* is an example of what Krattenmaker and Salop refer to as a "Cartel Ringmaster." Krattenmaker & Salop, *Anticompetitive Exclusion: Raising Rivals' Costs to Achieve Power Over Price*, *supra* note 1, at 93-104. While they categorize it as a form of "raising rivals' costs," the explicit horizontal market sharing agreement among the railroads that was enforced by Standard Oil is analytically distinct from the usual purely vertical form of "raising rivals' costs." Under the usual "raising rivals' costs" analysis, Standard Oil would monopolize refining by entering separate exclusive dealing vertical agreements with each railroad. In contrast, the anticompetitive arrangement in *Standard Oil* used an explicit horizontal market sharing agreement among the railroads enforced by Standard Oil. This could have been attacked legally with traditional Sherman Section 1 horizontal conspiracy doctrines, without

When there are substantial economies of scale in manufacturing, the possibility of establishing a stable conspiracy among a sufficient number of distributors that agree to exclusive distribution increases. The exclusive dealing cartel need not cover 100 percent of distribution. Exclusive contracts must only cover enough distribution for a long enough period of time so that manufacturing rivals do not have the ability to grow to minimum efficient size over a reasonable period of time.¹⁶ However, if there are sufficient economies of scale in distribution, so that an individual distributor can handle a manufacturer of minimum efficient scale, a dominant manufacturer would still have to contract on an exclusive basis with all distributors in order to effectively foreclose competitive manufacturers. In such circumstances, a competitive manufacturer could always enter at an efficient scale merely by winning one distributor contract. Therefore, as long as individual distributor contracts become available periodically, it is unlikely that an exclusive could foreclose competitive manufacturers from the market.

B. *Antitrust Liability Requires Substantial Foreclosure*

Antitrust law is consistent with economic analysis, in that an exclusive must cover a substantial share of the market for liability in Section 1 exclusive dealing cases. In the Supreme Court's last exclusive dealing case, *Tampa Electric Co. v. Nashville Coal Co.*, the Court used the lack of "substantial foreclosure" to conclude that an exclusive dealing contract covering less than one percent of the relevant market was not a violation of the antitrust laws.¹⁷ Earlier Supreme Court decisions, such as *Standard Fashion*¹⁸

resorting to any vertical antitrust doctrine such as "raising rivals' costs."

¹⁶ When manufacturers face significant economies of scope in distribution in addition to economies of scale in production, the critical foreclosure share may be reduced. Economies of scope exist, for example, when a manufacturer with a five percent market share has more effective distribution if it has five percent of the sales at all distributors rather than 100 percent of the sales at only five percent of the distributors.

¹⁷ The coal supply contract between Nashville Coal and Tampa Electric was found to cover less than one percent of coal supplied from the Appalachian area. Initially, the district court and the court of appeals focused on coal demanded in peninsular Florida as the relevant product and geographic market, finding a substantial "foreclosure" rate of more than 50 percent (or 18 percent if southern Georgia was included in the market). In contrast, the Supreme Court correctly recognized that there were 700 coal producers in the Appalachian coal area who could serve Tampa Electric and that Tampa's contract preempted at most 0.77 percent of this total coal volume *Tampa Elect. Co. v. Nashville Coal Co.*, 365 U.S. 320, 330-31, 333 (1961). A more recent Supreme Court case, *Jefferson Parish Hospital District No. 2 v. Hyde*, 466 U.S. 2 (1984), dealt with an exclusive dealing arrangement but was brought under tying law. Four Justices in a concurring opinion addressed exclusive dealing and concluded that "Exclusive deal-

and *Standard Stations*,¹⁹ found antitrust liability for exclusive dealing contracts that covered what the Court considered to be substantial market shares of 40 percent and 49 percent, respectively.²⁰ Although a number of lower court decisions after *Standard Stations* found antitrust liability in exclusive dealing cases covering relatively small market shares, the minimum market share that an exclusive contract must foreclose for a finding of antitrust liability has increased substantially over time, so that “recent decisions uniformly favor defendants where foreclosure levels are 40 percent or less.”²¹

The economic analysis presented above implies that the critical market share foreclosure rate should depend upon the minimum efficient scale of production. Unless there are very large economies of scale in manufacturing, the minimum foreclosure of distribution necessary for an anticompetitive effect in most cases would be substantially greater than 40 percent. Therefore, 40 percent should be thought of as a useful screening device or “safe harbor,” not an indication that anticompetitive effects are likely to exist above this level. In addition to covering a minimum share of distribution, anticompetitive exclusive contracts must be of significant duration.²² Both the number and duration of the exclusive contracts must be such that

ing is an unreasonable restraint of trade only when a significant fraction of buyers or sellers are frozen out of a market by the exclusive deal” *Jefferson Parrish*, 466 U.S. at 45. The Justices found that the exclusive contract was not an unreasonable restraint of trade because it foreclosed only 30 percent of the market, a foreclosure rate that did not permit the anesthesiologists entering into the contract to acquire market power over other anesthesiologists *Id.* at 46.

¹⁸ *Standard Fashion*, 258 U.S. at 346.

¹⁹ *Standard Oil Co. of Cal. v. United States*, 337 U.S. 293 (1949).

²⁰ In *Standard Stations*, Standard’s exclusive dealing contracts with its gasoline dealers covered only 6.7 percent of the relevant “western area” geographic market. But the Court noted that similar contracts were entered into by Standard’s six largest competitors covering another 42.4 percent of sales in the area *Id.* at 295, 314. Throughout the analysis that follows, market share refers to share covered by an individual firm’s exclusive dealing contract. Unless there is a conspiracy among manufacturers, there is no economic reason to sum the shares. When all manufacturers in an industry independently use an exclusive dealing contract, this should be considered evidence of the contract’s efficiency.

²¹ Jonathan M. Jacobson, *Exclusive Dealing, “Foreclosure,” and Consumer Harm*, 70 ANTITRUST L.J. 311, 362 (2002). Jacobson summarizes the law in the following way: “Post-Beltone [*i.e.*, since *In re Beltone Electronics Corp.*, 100 F.T.C. 68 (1982)], decisions [have] routinely sustained the legality of exclusive dealing arrangements with foreclosure percentages of 40 percent or less.” *Id.* at 325 n.85. Jacobson describes recent exclusive dealing law as requiring, rather than sufficient foreclosure (the pre-condition for an anticompetitive effect), merely a significant effect of the exclusive dealing arrangement on the defendant’s market power. However, market power can be affected only if there is sufficient foreclosure.

²² Judge Richard Posner has held that exclusive dealing contracts of one year or less are “presumptively lawful.” *Roland Mach. Co. v. Dresser Indus., Inc.*, 749 F.2d 380, 395 (7th Cir. 1984).

competitors do not have sufficient opportunities to grow to minimum efficient size in a reasonable amount of time.

Consistent with this legal requirement that an exclusive contract cover a significant share of the market for a significant period of time for antitrust liability, the *Microsoft* district court concluded that Microsoft's de facto exclusive distribution contracts with Internet access providers and personal computer manufacturers did not violate Section 1 because it found that the contracts did not cover more than 40 percent of the market.²³ The D.C. Circuit signaled its disagreement,²⁴ but did not reverse this ruling, which was unchallenged by the plaintiffs.

On the other hand, the district court concluded that Microsoft's exclusive contracts violated Section 2. The D.C. Circuit fully accepted this conclusion, holding that the exclusive contracts permitted Microsoft to obtain control of a substantial share of effective browser distribution in an attempt to illegally protect its market power in the personal computer operating system market.²⁵ Rather than adopting a somewhat counter-intuitive, more restrictive Section 2 than Section 1 legal standard for exclusive contracts, the essential analysis that underlies the Court's Section 2 reasoning can be thought of as advocating weighing distribution shares more heavily towards "cost-effective" distribution channels when calculating the degree of market foreclosure. Microsoft is said to have used exclusives to hinder Net-

²³ *Microsoft*, 87 F. Supp. 2d at 52. The district court does not describe the basis for its finding of a less than 40 percent foreclosure rate. However, 25 percent of users obtained their browsers from their Internet access provider and another 20 percent of users with the purchase of their personal computer Pls.' Proposed Findings of Fact at ¶ 362.1 (iii), *Microsoft*, 87 F. Supp. 2d 30 (Nos. 98-1232 (TPJ) & 98-1233 (TPJ)). Combining this with the fact that Microsoft's exclusive contracts with Internet access providers generally required only 75 percent to 85 percent Internet Explorer usage, and that not every user who obtained their browser software with the purchase of a computer used Internet Explorer, suggests an overall foreclosure rate that may have been less than 40 percent (.85 x .45 = 38 percent).

²⁴ The D.C. Circuit noted that "The District Court appears to have based its holding with respect to §1 upon a 'total exclusion test' rather than the 40% standard drawn from the case law." *Microsoft*, 253 F.3d at 70.

²⁵ *Id.* at 70-71. Consistent with this motivation for Microsoft's exclusive contracts, Bill Gates wrote in his infamous memo that Netscape's success in browser software may ultimately lead to the elimination of the applications barrier to entry and the commoditization of Windows. *Microsoft*, 84 F.Supp. 2d 9, 29 (D.D.C. 1999) (citing "The Internet Tidal Wave," May 26, 1995, *Microsoft* Trial R., GX 20 at MS9801128763). However, Microsoft's more immediate concern may have been that Navigator's success would create a successive monopoly problem. In particular, there was a reasonable expectation at the time of Microsoft's competition with Netscape for browser distribution that applications written explicitly for the Internet would grow dramatically. If Netscape had won the competition for browser distribution, Navigator would control the interface between Windows and these applications. As a consequence, even if Microsoft did not lose its dominance of the personal computer platform, it would lose some of its platform monopoly profits. In particular, any increase in Netscape's price of Navigator would have reduced Microsoft's profit-maximizing price of Windows, in addition to raising the total package price of operating system and browser software to consumers.

scape's ability to obtain distribution by dominating the two most cost-effective channels of browser distribution, through computer manufacturers and Internet access providers. By explicitly taking account of the cost-effectiveness of different channels, Microsoft's exclusive contracts could be said to cover more than 40 percent of "effective distribution," thereby meeting a consistent minimum foreclosure standard under both Section 1 and Section 2.²⁶

The D.C. Circuit recognized that it is not necessarily an antitrust violation when a firm with market power achieves a significant share of distribution in the marketplace. The Court acknowledged that competition for distribution is part of the normal competitive process, noting that "exclusive contracts are commonplace—particularly in the field of distribution—in our competitive, market economy."²⁷ Even firms with market power produce benefits for consumers when they actively compete and ultimately win the competition for distribution. Therefore, consumers would be harmed if a monopolist were required to "roll over" and not attempt to protect its market power by competing actively for distribution. However, while the Court accepted that Microsoft's attempt to preserve its power in the operating system market was "not an unlawful end,"²⁸ it concluded that Microsoft employed illegal *means* to achieve this legitimate end, namely that Microsoft's use of exclusive contracts did not involve "competition on the merits."

II. WHEN IS COMPETITION FOR DISTRIBUTION NOT "ON THE MERITS"?

The D.C. Circuit in *Microsoft* defines "competition on the merits" as competition that "involves, for example, greater efficiency or enhanced consumer appeal."²⁹ If manufacturers are competing for distribution contracts on this basis on a "level playing field," where no manufacturer has an

²⁶ The District Court found that, even if Microsoft had not engaged in its exclusionary behavior and Netscape had successfully competed with Microsoft for browser distribution, it was unlikely that Navigator (or Navigator/Java) would have developed into an alternative competitive personal computer platform to Windows *Microsoft*, 84 F. Supp. 2d at 111-12. Fox relies on this finding to assert that *Microsoft* stands for the proposition that firms with significant market power cannot engage in exclusionary conduct independent of whether there is an actual or likely anticompetitive effect in a relevant market. Fox, *What Is Harm To Competition? Exclusionary Practices and Anticompetitive Effect*, *supra* note 6. Although there may be some difficulty in reconciling the Court's ultimate decision with this finding of fact, this potential inconsistency is a slim reed upon which to reject established antitrust law.

²⁷ The Court continued: "and imposing upon a firm with market power the risk of an antitrust suit every time it enters into such a contract, no matter how small the effect, would create an unacceptable and unjustified burden upon any such firm." *Microsoft*, 253 F.3d at 70.

²⁸ *Id.* at 71.

²⁹ *Id.* at 59.

artificial advantage over any other, more efficient manufacturers cannot be driven out of the market and distributors will receive the full market value from manufacturers for their distribution. Competition among distributors for consumers then can be expected to pass this value on to consumers. In this way, “competition on the merits” for distribution contracts is an important part of the normal competitive process. As Judge Frank Easterbrook states, “[c]ompetition-for-the-contract is a form of competition that antitrust laws protect rather than proscribe, and it is common.”³⁰

One form of competition that is not considered “competition on the merits” involves the leveraging of market power via illegal tying. The competition-for-the-contract in such a case may not be on “a level playing field.” For example, consider competition between Microsoft and Netscape for browser distribution by personal computer manufacturers. Microsoft possessed an inherent advantage over Netscape in this competition because personal computer manufacturers had to license Windows to remain in business. Therefore, Microsoft could have foreclosed Netscape completely from the personal computer channel by exclusively tying Internet Explorer to Windows.³¹

In contrast, Microsoft had no fundamental advantage over Netscape in competing for browser distribution by Internet access providers. Microsoft appears to have won this competition solely because it offered Internet access providers (and therefore indirectly Internet access subscribers) more than Netscape. Yet the Court condemned Microsoft’s success in achieving

³⁰ Paddock Publ’ns., Inc. v. Chicago Tribune Co., 103 F.3d 42, 45 (7th Cir. 1996).

³¹ Microsoft could have accomplished this by, for example, contractually requiring Internet Explorer exclusivity, so that computer manufacturers could not distribute Navigator. Alternatively, Microsoft could have accomplished this by not supplying the necessary application program interfaces (APIs) to Netscape, so that Navigator would not work with Windows. This would have effectively foreclosed Navigator not only from the computer manufacturer channel, but from the entire market. Microsoft did neither of these things. In fact, Microsoft did not enter exclusive browser distribution contracts with most computer manufacturers. What Microsoft did was to include Internet Explorer in Windows and contractually prevent computer manufacturers from removing the IE icon from the Windows desktop, as well as prevent computer manufacturers from making any alterations in the initial boot sequence or appearance of the Windows desktop. *Microsoft*, 253 F.3d at 61-62. These actions did not amount to de facto Internet Explorer contractual exclusivity by computer manufacturers. See Benjamin Klein, *The Microsoft Case: What Can A Dominant Firm Do To Defend Its Market Position?*, 15 J. ECON. PERSPECTIVES 45 (2001). The Court determined that aspects of this behavior (in addition to Microsoft’s design decision to eliminate IE from the Windows “Add/Remove Programs” utility) violated Section 2 because it created an advantage for Microsoft over Netscape in competing for distribution in the personal computer channel that could not be justified on efficiency grounds *Microsoft*, 253 F.3d at 59-67. However, the Court recognized that the Section 1 tying issues were complicated by the possibility that the inclusion of Internet Explorer in Windows may have involved efficient software design decisions that it did not wish to second-guess and reversed and remanded the district court’s finding of a tie-in violation. *Id.* at 92-95.

Internet access distribution because the competition did not occur “on the merits.”

In attempting to understand what the Court meant by the absence of “competition on the merits,” consider the competition between Microsoft and Netscape in 1996 for browser distribution by America Online, the largest Internet access provider.³² America Online intended to adopt a new browser technology that it wished to incorporate into its proprietary access software that it distributed to its subscribers.³³ Since usage by America Online’s subscriber base was valuable to Microsoft and Netscape in their ongoing browser competition, Microsoft and Netscape both competed actively for the contract.

Microsoft ultimately won the contract to supply browser software to America Online because it offered America Online superior terms. In particular, Microsoft agreed to: (1) license Internet Explorer at a zero price; (2) develop a “componentized” or modular version of Internet Explorer; and (3) include America Online in the online services folder of the Windows desktop free of charge.³⁴

Netscape, who had been charging Internet access providers between \$15 and \$20 per copy of Navigator,³⁵ met Microsoft’s zero price. However, Netscape did not meet Microsoft’s other non-price terms. Indeed, Netscape’s final offer involved plans to charge America Online for the technical work necessary to componentize Navigator and provided no additional consideration to meet Microsoft’s offer to America Online of free space in the Windows online services folder.³⁶

In return for Microsoft’s consideration, America Online agreed to integrate Internet Explorer into the Internet access software provided to its subscribers and not to promote any other browser for two years, contractually guaranteeing that a minimum of 85 percent of its new subscribers

³² The following is largely based on Klein, *The Microsoft Case: What Can A Dominant Firm Do To Defend Its Market Position?*, *supra* note 31 and Benjamin Klein, *Did Microsoft Engage in Anticompetitive Exclusionary Behavior?* ANTITRUST BULL. 71 (2001).

³³ It was “AOL’s intention to select one firm’s Web browsing software and then to work closely with that firm to incorporate its browsing technology seamlessly into the AOL flagship client software. Regardless of which software it chose as its primary offering, though, AOL still wanted the ability to satisfy consumer demand for competing Web browsing software. AOL did not want users who preferred a certain brand of Web browsing software to have to go to a competing OLS in order to obtain it.” (*Microsoft*, 84 F. Supp. 2d at 82).

³⁴ *Microsoft*, 253 F.3d at 67-68; *Microsoft*, 84 F. Supp. 2d at 79. Componentization permitted America Online to customize Internet Explorer by putting its own shell and branding on the browser so that subscribers would see the America Online home page and features as their start page.

³⁵ *Microsoft*, 84 F. Supp. 2d at 71.

³⁶ MICHAEL A. CUSUMANO & DAVID B. YOFFIE, *COMPETING ON INTERNET TIME: LESSONS FROM NETSCAPE AND ITS BATTLE WITH MICROSOFT* 115-18, 184-85 (1998).

would use Internet Explorer technology during the term of the contract.³⁷ Microsoft made similar agreements with all the other leading Internet access providers.³⁸

Microsoft's success in obtaining Internet access provider distribution did not rely on the exercise of any market power advantage it possessed over Internet access providers by virtue of its ownership of Windows. While Microsoft offered America Online and other Internet access providers free valuable space in the Windows online services folder, this space was not an indispensable input that Internet access providers had to obtain to remain in business. In fact, Microsoft overcame its initial reluctance to provide America Online with space on the Windows desktop after it recognized that America Online was already obtaining prominent desktop space by purchasing it directly from computer manufacturers, a practice which America Online continued after Microsoft provided them with space in the Windows online services folder.³⁹ Placement on the Windows desktop, therefore, was not an essential facility for Internet access providers. Microsoft could have sold Windows placement to Internet access providers, but instead used it as the currency to obtain distribution. Netscape lost the competition for the contracts, in part, because it failed to meet this payment by Microsoft for Internet access provider distribution with some other consideration, not because Microsoft possessed a significant market power advantage over Internet access providers that it used in the bidding. Microsoft won merely because it offered Internet access providers, and indirectly Internet access subscribers, a better deal.

A. *Predatory Overcompensation of Distributors*

The Department of Justice claimed that Microsoft's competition for Internet access provider distribution was anticompetitive because it was predatory. In particular, Microsoft's setting of a zero price for Internet Explorer, as well as the R&D costs of designing a componentized browser and providing free space on the Windows desktop involved very large costs that could only make economic sense if Microsoft was successful in maintaining its dominance of the operating system platform.⁴⁰ Therefore, although Microsoft's actions produced short-term benefits for Internet access providers, and indirectly consumers, they also may have imposed larger longer-

³⁷ *Microsoft*, 253 F.3d at 68.

³⁸ *Id.*

³⁹ *Microsoft*, 84 F. Supp. 2d at 79-80.

⁴⁰ *Microsoft*, 87 F. Supp. 2d at 42; Professor Franklin Fisher, U.S. Dept. of Justice expert economic witness, Jun. 1, 1999 p.m. testimony at 39-40, *Microsoft*, 87 F. Supp. 2d 30 (Nos. 98-1232 (TPJ) & 98-1233 (TPJ)).

term costs on consumers. The antitrust concerns with below-cost predatory pricing is that such alleged overpayment for browser distribution may have led Netscape to give up the battle for dominance of the browser business sooner than otherwise and, by creating an aggressive competitor reputation for Microsoft, may have deterred the entry of other potential rivals in the future.

The government's evidence that Microsoft paid "too much" to obtain Internet access provider distribution for Internet Explorer was a comparison of the large costs borne by Microsoft in winning the Internet access provider accounts with the very small, if nonexistent, direct financial benefits Microsoft received from increased Internet Explorer distribution and usage.⁴¹ Microsoft was essentially supplying Internet Explorer at a negative price in an attempt, it was claimed, to "cut off [Netscape's] air supply."⁴²

Supplying products at a negative price is not entirely unusual when purchasing distribution. For example, broadcast TV networks supply their programming at a negative price to their local TV station affiliates. The local stations supply an audience that the TV networks use to sell the advertising they imbed in their programming. In this case, however, Microsoft could not expect Internet Explorer distribution by Internet access providers to increase its advertising revenue and e-commerce commissions. Traffic was not increased on Microsoft's website because Microsoft supplied a componentized browser that permitted Internet access providers to funnel subscribers to their own websites.

Suppliers of browser software may have other ways to make money from increased distribution. When Netscape originally decided to give away large quantities of browser software in 1994, it was primarily to build a user base for its server and browser-related enterprise software.⁴³ This business strategy is similar to the zero pricing adopted for "viewer" software such as Adobe's Acrobat reader and the RealNetworks' multimedia player. The full competitive price of browser software similarly may be negative, in the sense that browser suppliers may find it profitable to spend money to get consumers to adopt their browser.

Microsoft similarly justified its payments to Internet access providers by claiming that increased Internet Explorer usage encouraged increased future sales of Windows. This was accomplished, Microsoft maintained, by

⁴¹ *Microsoft*, 87 F.Supp. at 42.

⁴² Microsoft's Vice President Paul Maritz allegedly told Intel Corporation executives that this was Microsoft's intent. See Steve Lohr & John Markoff, *Why Microsoft is Taking a Hard Line with the Government*, N.Y. TIMES, Jan. 12, 1998, at D1; see also Dept. of Justice Prelim. Inj. Ex. 4, *Microsoft*, 87 F. Supp. 2d 30 (Nos. 98-1232 (TPJ) & 98-1233 (TPJ)).

⁴³ MICHAEL A. CUSUMANO & DAVID B. YOFFIE, *supra* note 36, at 99.

keeping software developers focused upon the Windows platform.⁴⁴ However, this is exactly what the Department of Justice categorized as the anti-competitive motivation for Microsoft's overcompensation of Internet access—providers—that it permitted Microsoft to preserve its Windows operating system monopoly by reducing the incentive to write applications for Navigator that would work with competing operating systems. In a fundamental sense, therefore, Microsoft and the plaintiffs basically were in agreement regarding Microsoft's economic motivation; their primary disagreement dealt with whether the anticompetitive predatory label should be placed on the conduct.

The plaintiffs argued that Microsoft's actions were predatory because the conduct only made economic sense if Microsoft expected its actions to preserve its monopoly profits on Windows.⁴⁵ However, in cases where firms are competing for a natural monopoly, such as control of the personal computer platform, this Ordovery-Willig standard⁴⁶ for defining predatory behavior does not work. The expected returns from firms' competitive actions always will involve the creation or maintenance of monopoly power.

Consistent with recent Supreme Court precedents on predatory pricing, the district court did not assign liability for Microsoft's alleged predatory pricing and the plaintiffs did not press their predatory claims on appeal.⁴⁷ Reinforcing, if not increasing the hurdle for a finding of antitrust liability for aggressive price competition, the D.C. Circuit stated that “[t]he rare case of price predation aside, the antitrust laws do not condemn even a monopolist for offering its product at an attractive price, and we therefore have no warrant to condemn Microsoft for offering [Internet Explorer] free of charge or even at a negative price.”⁴⁸

The Court appears to believe that competing for distribution with increased distributor compensation, no matter how large the compensation, generally involves “competition on the merits.” This view makes a great deal of economic sense. Because the Internet access industry was highly competitive, much of the compensation received by Internet access provid-

⁴⁴ *Microsoft*, 253 F.3d at 71.

⁴⁵ Professor Franklin Fisher, Dept. of Justice economic expert, Direct Testimony, ¶¶ 122-24, *Microsoft*, 87 F. Supp. 2d 30 (Nos. 98-1232 (TPJ) & 98-1233 (TPJ)); Plaintiffs' Joint Proposed Findings of Fact, ¶¶ 301-02, *Microsoft*, 87 F. Supp. 2d 30 (Nos. 98-1232 (TPJ) & 98-1233 (TPJ)).

⁴⁶ See Janusz A. Ordovery & Robert D. Willig, *An Economic Definition of Predation: Pricing and Product Innovation*, 91 YALE L.J. 8 (1981).

⁴⁷ Although the court did not explicitly say so, it is unlikely that Microsoft's conduct would likely drive Netscape from the browser market and lead to recoupment by future monopoly pricing of browser software. See *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574 (1986); *Atlantic Richfield Co. v. USA Petroleum Co.*, 495 U.S. 328 (1990); *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209 (1993).

⁴⁸ *Microsoft*, 253 F.3d at 68.

ers (including the saved payments they would otherwise have had to make to Microsoft for browser software or for valuable space in the Windows online services folder) was very likely passed on to subscribers in the form of lower access fees or improved services. There is no fundamental economic difference between Microsoft competing with Netscape directly for consumer browser usage with a zero or negative browser price and Microsoft competing with Netscape indirectly for usage with payments to Internet access providers for distribution. These expenditures by Microsoft are a key element of the competitive process, even if the expenditures are aimed at preserving its market power.

B. *The Possibility of Undercompensation of Distributors*

There are two other economic theories under which competition for distribution by a dominant incumbent firm is sometimes claimed not to occur entirely “on the merits.” Both of these theoretical “distortions” of the competitive process result in undercompensation, rather than overcompensation, of distributors. However, both of these theories have limited anti-trust relevance.

One theory, first described by Rasmusen, Ramseyer and Wiley,⁴⁹ involves the use of exclusives by a dominant manufacturer to create expectations among distributors that the manufacturer will drive out competitors, which leads to a “rush” by distributors to sign exclusives in order to avoid being left out of what they believe is likely to be a manufacturer monopoly.

As described above, the difficulty in establishing any cartel, especially a distribution cartel, is that it is generally more profitable for an individual distributor to remain outside of the cartel by not entering into the exclusive distribution arrangement. Under these circumstances, a manufacturer cannot offer individual distributors enough so that they will find it in their economic interests to join the cartel. However, a dominant manufacturer may be able to circumvent these economic forces and establish an effective distribution conspiracy if it creates expectations among distributors that competing manufacturers will be driven out of the market. If there are sufficient economies of scale in manufacturing, distributors may believe that if enough of them enter exclusives with the dominant manufacturer, there will not be effective distribution remaining that can support a manufacturer of minimum efficient scale. Individual distributors may then believe that a failure to agree at an early stage to an exclusive will result in either being driven out of the market, or the necessity to purchase the dominant manu-

⁴⁹ Eric Rasmusen et al., *Naked Exclusion*, 81 AM. ECON. REV. 1137 (1991); see also Ilya R. Segal & Michael D. Whinston, *Naked Exclusion: Comment*, 90 AM. ECON. REV. 296 (2000).

facturer's product at a monopoly price. Therefore, individual distributors will reduce their demand for manufacturer compensation for agreeing to an exclusive, making it possible for the dominant manufacturer to profitably sign exclusives over a sufficient share of distribution to foreclose manufacturer competitors.

The crucial economic insight of this model is that each distributor agreeing to an exclusive ignores the impact of its decision on the overall competitiveness of the market for the purchase of distribution services. In particular, each distributor ignores the fact that its commitment to exclusivity has the "externality" of increasing the likelihood that rival manufacturers will be driven out of the market. Once distributors expect a manufacturer is likely to succeed in driving out its rivals, rather than each individual distributor having an incentive to stay out of the distribution conspiracy organized by the dominant manufacturer, there may be a "rush" by distributors to sign the exclusive to avoid being left out of the distribution conspiracy.

When this effect is operating, competitive bidding by manufacturers for distribution can break down. A manufacturer may be able to obtain monopoly control of distribution, even if competing manufacturers are offering distributors superior terms. In practice, however, it is extremely difficult to determine when this possible distortion of the competitive bidding process is taking place. The winning firm may appear to be offering inferior price terms compared to competitors, but this merely may reflect higher expected quality of its product. Moreover, even if such behavior were found to be present, it is not obvious exactly what, if any, competitive conduct the regulatory authorities should enjoin.

It is clear, however, that this scenario did not apply to Microsoft's exclusive contracts with Internet access providers since Microsoft's competitive actions were extremely unlikely to drive Netscape out of the browser software business. Internet access providers could reasonably assume that both browser suppliers would co-exist, certainly for a longer period than the two-year term of the exclusive contracts Microsoft was negotiating. Moreover, Microsoft was committing to maintain its zero Internet Explorer price. As a consequence, there was not a rush by Internet access providers to sign up with Microsoft to avoid a future monopoly price of browser software. This is consistent with the evidence that Microsoft won the competition for Internet access provider browser distribution not by offering less than Netscape, but by offering substantially more than Netscape.

A second economic theory in which competition for distribution has been claimed not to occur entirely "on the merits" is when a dominant incumbent firm has a significant advantage in bidding for distribution because it previously has made significant sunk investments. In this situation,

the incumbent has more to gain from winning the competition for distribution than the entrant. If the incumbent wins the competition for distribution, it maintains its monopoly. On the other hand, if the entrant wins the competition for distribution, it is assumed that the incumbent and entrant operate for a time under a duopoly.⁵⁰ Therefore, because winning the competition for distribution is worth more to the incumbent dominant firm, the incumbent will generally find it worthwhile to bid more than entrants when competing for distribution. This may explain why Netscape offered Internet access providers substantially less than—Microsoft—because it knew that Microsoft would always find it worthwhile to win the competition for browser distribution.

Once again, there are no obvious antitrust policy conclusions that flow from this analysis. New entrants frequently challenge dominant firms and the advantage of incumbency is not determinative. In spite of its control of Windows, Microsoft had to invest very large amounts in browser technology and make large payments for distribution to avoid Navigator's dominance of browser software. While a dominant incumbent generally has the incentive to make larger, more rapid investments because of its larger potential payoff, Microsoft's experience in failing to extend its personal computer platform dominance to, for example, hand-held and wireless devices indicates that an incumbent may still lose a competitive battle if its responses are delayed or inadequate. This is what encourages entrants to challenge incumbent monopolists, notwithstanding the fact that the incumbent may have more to gain in the competitive battle. It also explains why we would not want to adopt any legal rules that artificially constrain the ability of an incumbent dominant firm to "compete on the merits."

In concluding that competition for Internet access provider distribution was not "on the merits," the court did not focus on these two supposed defects in the competitive process. In particular, the court did not consider whether Microsoft's incumbent advantage created a "rush" by Internet access providers to sign up with Microsoft or discouraged Netscape from actively trying to win Internet access accounts. There is absolutely no anti-trust case law that considers these potential theoretical economic factors relevant.

In declaring that Microsoft's competition for Internet access provider distribution was not "on the merits," the Court was not concerned about whether Microsoft paid too much or too little for Internet distribution, that

⁵⁰ This is similar to models of entry deterrence where an incumbent firm that has already borne the required sunk fixed costs will not exit immediately in response to new firm entry. See Steven C. Salop, *Strategic Entry Deterrence*, 69 AM. ECON. REV. 335 (1979). In the Microsoft-Netscape case, if Netscape won the competition for distribution, its return would be lower because it would operate under a successive monopoly. See *supra* note 25.

is, whether Microsoft engaged in predatory browser pricing to overpay for distribution or took advantage of its incumbent position to underpay for distribution. Instead, what the court was concerned about was the form of Microsoft's contracts for Internet distribution. Specifically, the court considered Microsoft's de facto exclusives with Internet access providers to lack any legitimate business justification.⁵¹ While it was pro-competitive for Microsoft to pay Internet access providers to carry Internet Explorer, Microsoft provided no justification for paying Internet access providers not to carry other browsers.⁵² According to the court, without a legitimate efficiency justification, these payments for exclusivity unnecessarily restricted Netscape's ability to obtain distribution.⁵³ Microsoft's exclusive contracts, therefore, did not involve "competition on the merits." Given the legal importance of establishing an efficiency rationale for exclusive contracts, we now turn to a detailed economic discussion of why a manufacturer may legitimately use exclusive dealing in its distribution contracts.

III. THE EFFICIENCIES OF EXCLUSIVE DISTRIBUTION CONTRACTS

A. *Exclusivity Prevents Distributor "Free-Riding" on Manufacturer Investments*

A commonly recognized efficiency rationale for exclusive dealing is the protection of manufacturer property rights on investments manufacturers provide to distributors. For example, a manufacturer may make investments in training a distributor's sales staff or in constructing a distributor's showroom. The manufacturer makes these investments expecting to earn a return on increased distributor sales of its products. After the manufacturer makes such investments, however, distributors may have an incentive to "free-ride" by using the investments to sell the products of manufacturing rivals. Exclusive dealing, by preventing this "free-riding," encourages manufacturers to make efficient distributor investments.⁵⁴

⁵¹ *Microsoft*, 253 F.3d at 71.

⁵² "Microsoft's only explanation for its exclusive dealing is that it wants to keep developers focused upon its APIs -- which is to say, it wants to preserve its power in the operating system market. . . . That is not an unlawful end, but neither is it a procompetitive justification for the specific means here in question, namely exclusive dealing contracts with IAPs [Internet access providers]." *Id.* at 71.

⁵³ *Id.* at 70-71.

⁵⁴ See Howard P. Marvel, *Exclusive Dealing*, 25 J.L. & ECON. 1 (1982) for the leading statement of this analysis. Because the manufacturer's investments can be used by the distributor to sell rival products, the investments are considered "external" in the terminology of Segal and Whinston. Ilya R.

The protection of a manufacturer's investments in distributors is an efficiency rationale for exclusive contracts that makes economic sense and is widely accepted in antitrust law. For example, in *Ryko*⁵⁵ the court recognized that exclusives made it more likely the manufacturer would pay for dealer showroom fixtures and undertake sales training programs for the dealers' salespeople. Without an exclusive contract, the manufacturer would be less likely to make these desirable distributor investments because the manufacturer would know that dealers could use the investments to sell rival products.⁵⁶

Similarly, "free-riding" on manufacturer investments may explain the exclusive contracts between gasoline refiners and dealers that were the subject of *Standard Stations*.⁵⁷ Refiners made investments in dealer stations that included the provision of pumps and signage, as well as frequently subsidizing station rent.⁵⁸ Refiners expected to earn a return on these investments in dealer sales of their gasoline.⁵⁹ The exclusive, therefore, prevented gasoline dealers from "free-riding" by switching customers to lower-cost gasoline from suppliers who had not made these investments.⁶⁰

Segal & Michael D. Whinston, *Exclusive Contracts and Protection of Investments*, 31 RAND J. ECON. 603 (2000). Segal and Whinston agree that under these circumstances exclusive dealing encourages manufacturers to make distributor investments. *Id.* Segal and Whinston argue, however, that exclusive dealing does not protect "internal" investments that cannot be used by the distributor to sell rival products. *Id.*; see also *infra* note 64.

⁵⁵ *Ryko Mfg. Co. v. Eden Servs.*, 823 F.2d 1215, 1234 & n.17 (8th Cir. 1987).

⁵⁶ A similar efficiency justification was accepted in *Roland Machinery Co. v. Dresser Industries*, 749 F.2d 380, 395 (7th Cir. 1984).

⁵⁷ *Standard Oil Co. of Cal.*, 337 U.S. 293.

⁵⁸ Refiners reduced rent subsidies after the "oil shocks" of 1973 and 1979, as gasoline became a more fungible commodity (so that the gap between the refiner's wholesale price and its marginal cost and, hence, the incentive to expand incremental sales, was reduced) and the number of gasoline stations contracted dramatically. See U.S. DEPARTMENT OF ENERGY, DEREGULATED GASOLINE MARKETING: CONSEQUENCES FOR COMPETITION, COMPETITORS AND CONSUMERS (Mar. 1984).

⁵⁹ In addition to the exclusive purchase of gasoline, some contracts also required station operators to purchase all their requirements of tires, batteries and accessories from the refiner. *Standard Oil Co. of Cal.*, 337 U.S. at 296.

⁶⁰ The exclusive contracts between gasoline refiners and dealers also may be explained in terms of quality control. When products, such as gasoline, are not pre-packaged by the manufacturer, the switching of customers to lower-cost supplies may occur without the customer's knowledge. In particular, customers switched to an alternative gasoline may believe they are actually receiving the nationally advertised refiner's brand. Exclusives control quality by preventing dealers from "passing off" the product as the refiner's. Although gasoline of a given grade may be relatively fungible under current exclusive arrangements, without an exclusive individual dealers would have an incentive to mix cheaper, lower quality gasoline with the refiner's gasoline and sell it under the refiner's name. Individual dealer incentives with regard to quality supply may not coincide with refiner quality incentives because the costs of reduced quality are borne at least partially by all other dealers using the refiner's name. See Benjamin Klein, *The Economics of Franchise Contracts*, 2 J. CORP. FIN. 9 (1995). This

This “free-riding” problem also may exist when distributors cannot costlessly use the investments made by a manufacturer to sell a rival manufacturer’s products. For example, a manufacturer may make investments in advertising or in generating specific customer leads that are then referred to distributors. In contrast to a manufacturer’s investments in a distributor’s showroom or in general sales training that may be used to sell any manufacturer’s product, these investments in advertising and customer leads may create potential customers who ask the distributor for the manufacturer’s product. Therefore, the distributor will have to make some additional point of sale efforts to switch sales to a rival brand. But, without an exclusive contract, the distributor still may have an incentive to switch customers if the rival brand has a higher profit margin. An exclusive contract protects against this potential “free-riding” by the distributor on the manufacturer’s investments.

Prevention of this type of “free-riding” is illustrated in *Beltone Electronics*.⁶¹ Beltone, a hearing aid manufacturer, used advertising to generate sales leads that were supplied to its distributors, who were prohibited from carrying competing hearing aid brands.⁶² Such an arrangement makes economic sense when there are efficiencies of national advertising, that is undertaken by the manufacturer, and no significant consumer benefits of multi-brand distribution. The exclusive prevents distributor switching and thereby permits Beltone to collect through the sales of its distributors the full return on its investments in generating customer leads.⁶³

Finally, exclusive dealing may be used to protect manufacturer investments that cannot be used by the distributor at all to make sales of another brand.⁶⁴ After a manufacturer makes such distributor investments, the

quality control argument was accepted by the court in *FTC v. Sinclair Refining Co.*, 261 U.S. 463 (1923) to justify the requirement that dealers use a refiner’s gasoline exclusively in the pumps and equipment supplied and labeled by the refiner. However, it also may justify station-wide exclusive contracts as a way to efficiently reduce the refiner’s costs of monitoring quality. With station-wide exclusives, as opposed to split-pump arrangements, the refiner need not actually determine if dealers are mixing lower-cost, lower-quality gasoline in the refiner’s gasoline tanks. If the refiner sees a truck from another company delivering gasoline at one of its stations, the refiner knows the dealer is violating the contract without determining if the gasoline actually was mixed in the refiner’s tanks and whether the mixed gasoline meets the refiner’s quality standards. See Benjamin Klein & Lester Saft, *The Law and Economics of Franchise Tying Contracts*, 28 J. L. & ECON. 345 (1985) for a discussion of this quality-monitoring efficiency rationale for franchise requirements contracts.

⁶¹ *In re Beltone Elec. Corp.*, 100 F.T.C. 68.

⁶² *Id.* at 2-9.

⁶³ See Howard P. Marvel, *Vertical Restraints in the Hearing Aids Industry*, in IMPACT EVALUATIONS OF FEDERAL TRADE COMMISSION VERTICAL RESTRAINT CASES 270-384 (Ronald N. Lafferty et al. eds., 1984).

⁶⁴ These distributor-specific investments are what Segal and Whinston refer to as “internal” in-

distributor may attempt to “hold up” the manufacturer by threatening not to distribute the manufacturer’s products. If this threat is carried out, the manufacturer will experience a capital loss on its investments. Renegotiation of the distribution contract under such a holdup threat, therefore, may permit the distributor to achieve a wealth transfer equal to a fraction of the manufacturer’s investments. An exclusive dealing contract reduces this potential holdup because the distributor can no longer credibly threaten to terminate its purchases from the manufacturer. Under an exclusive, distributor termination of the manufacturer would impose a large cost on the distributor because it will not be able to sell any other manufacturer’s product.⁶⁵

This rationale explains exclusive distribution contracts where the manufacturer’s investments cannot be used to sell another brand, such as when the manufacturer is providing training to the distributor’s sales staff that can be used only to sell the manufacturer’s products. An exclusive provides the manufacturer with assurance that distributors will not attempt a holdup after the manufacturer makes such investments.

These economic forces are clearly illustrated in the Supreme Court’s last exclusive dealing case, *Tampa Electric*.⁶⁶ Tampa Electric, an electric utility located in Tampa, Florida, built a new plant that used coal-burning generators, rather than the oil-burning generators it had traditionally used. In connection with this construction Tampa contracted with Nashville Coal Company for the plant’s coal supply, and Nashville had to make significant Tampa-specific investments in order to perform.⁶⁷ Since Nashville would

vestments. Segal & Whinston, *Exclusive Contracts and Protection of Investments*, *supra* note 54.

⁶⁵ This use of exclusive contracts to avoid a holdup of “internal” specific investments was originally discussed in Benjamin Klein et al., *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J.L. & ECON. 297 (1978) with regard to the 1919 exclusive contract entered into by Fisher Body and General Motors. Segal and Whinston argue that exclusives do not protect a manufacturer’s investments in such cases because there will be a 50-50 sharing of the surplus created by the manufacturer’s specific investments independent of whether an exclusive contract is present or not. Segal & Whinston, *Exclusive Contracts and Protection of Investments*, *supra* note 54. The transactors are considered bilateral monopolists bargaining over the surplus from the specific investments, and it is assumed that this surplus is all the transactors have to lose if agreement is not reached. More realistically, however, the commitment by a distributor to purchase exclusively from a particular manufacturer reduces the distributor’s threat point in this bilateral bargaining and, therefore, the distributor’s ability to hold up the manufacturer. A distributor operating under an exclusive that wished to continue operating could no longer credibly threaten to stop purchasing from the manufacturer. See Benjamin Klein et al., *The Use of Exclusive Dealing to Protect Specific Investments* (2003) (unpublished manuscript, on file with the author).

⁶⁶ *Tampa Elect.*, 365 U.S. 320.

⁶⁷ Nashville Coal made investments in excess of \$7.5 million to prepare for the shipment of the coal involved in the contract from its Uniontown, Kentucky mine to Tampa Electric’s dock in Tampa,

not have made these investments without assurance that it could sell its coal at a reasonable price to Tampa for a number of years,⁶⁸ the 1955 contract entered into by the parties contained a 20-year exclusive purchase commitment by Tampa.⁶⁹ This commitment prevented Tampa from being able to credibly threaten Nashville, after Nashville had made its Tampa-specific investments, that it would buy coal elsewhere unless Nashville lowered its price or otherwise adjusted its contract terms. By protecting against such a holdup, the exclusive dealing contract permitted Nashville Coal to make efficient Tampa-specific investments.⁷⁰

B. *Exclusivity Facilitates Manufacturer Contracting For Distributor Promotion*

Although the economic rationale for exclusive contracts as a way to prevent distributors from free-riding on manufacturer investments is intuitively appealing, the full economic analysis underlying this rationale is not

Florida Pet. For Writ of Cert., at 23, *Tampa Elect.*, 365 U.S. 320 (No. 87).

⁶⁸ Br. for Pet'r Tampa Elect. Co. at 39, *Tampa Elect.*, 365 U.S. 320 (No. 87).

⁶⁹ Compl. at Ex. A, *Tampa Elect.*, 168 F.Supp. 456 (No. CIV 2418) (Tampa Electric-Nashville Coal Contract).

⁷⁰ Rather than assuring demand for the seller, Nashville Coal, who had made Tampa-specific investments, the Supreme Court briefly describes the efficiencies associated with the exclusive contract in terms of assuring supply to the buyer, Tampa Electric. *Tampa Elect.*, 365 U.S. at 334. However, these efficiencies do not appear applicable because there is no evidence that the buyer, Tampa Electric, made any investments that were specific to Nashville Coal. In the regulated environment in which it was operating Tampa Electric may have wanted a long-term coal price commitment to justify spending the \$3 million added cost of a coal-burning plant compared to an oil-burning plant. See *Tampa Elect.*, 365 U.S. at 323 (setting forth the increased cost estimate). But price uncertainty was reduced with a long-term, fixed price formula, requirements commitment by Nashville Coal, not with the Tampa Electric exclusive commitment. In fact, the long-term, fixed price requirements contract, which set the net delivered coal price at \$6.40 per ton indexed over time to changes in Nashville's labor and supply costs with a maximum total escalation of 32 cents per ton in each of the four consecutive five-year periods, did not track market coal prices. See Compl. at Ex. A, *Tampa Elect.*, 168 F.Supp. 456 (No. CIV 2418) (Tampa Electric-Nashville Coal Contract). Market coal prices almost immediately moved significantly above contractually set coal prices, increasing during the first 2 years of the contract by significantly more than the 5 percent maximum set for the entire initial 5-year period in the 20 year contract. Government price indices for bituminous coal increased by nearly 13 percent between 1955 and 1957 and, consistent with these market price changes, the proposed long-term contract from Peabody Coal Company to replace Nashville Coal supplies quoted a much higher delivered price of \$7.316 per ton. See *Table 7.8 Coal Prices, 1949-2002*, at <http://www.eia.doe.gov/emeu/aer/txt/ptb0708.html>; Aff. of William C. MacInnes, Ex. A, R. at 33-41. After market prices had moved significantly above contractually set prices, Nashville Coal notified Tampa Electric in 1957 that it would not perform under its requirements contract because Tampa's agreement to buy exclusively from Nashville was an antitrust violation. *Tampa Elect.*, 365 U.S. at 323.

obvious. First of all, it is not clear why manufacturers provide investments to distributors free of charge, or at subsidized prices. If the manufacturer could, for example, sell the assets created by its investments directly to distributors at their full value, either for an upfront payment or for a per unit time rental fee, the manufacturer would not have to use an exclusive contract to control distributor free-riding. Distributors would have the appropriate incentive to use the assets most efficiently in selling one or many brands and the manufacturer would receive a market return on its investments.

When the manufacturer investments consist of sales leads, as in *Bel-tone*, it may seem reasonable for the manufacturer to make the investments and to collect its return on distributor sales. Because of economies of scale in purchasing advertising, the manufacturer is likely to have a comparative advantage in generating sales leads. By collecting for these leads only when a sale is made, rather than selling the leads to distributors directly, the value of the leads are more easily measured, which may create an increased incentive for the manufacturer to perform. However, it is less clear why manufacturers provide distributors with subsidized fixtures or sales training, as in numerous other exclusive dealing cases. Moreover, given that these manufacturer investments in distributors can be used to sell other brands, it is unclear why manufacturers do not collect for the investments up front.

Assuming that a manufacturer supplies assets to its distributors at less than cost, a second aspect of the protection of manufacturer investments theory of exclusive dealing that remains incomplete is exactly why this creates an incentive for distributors to use the manufacturer-supplied assets to sell rival products. Obviously, if there is a higher profit margin on rival products, the distributor has an incentive to switch customers to rival brands. But the reason why rival brands are likely to have a higher profit margin is not satisfactorily explained by the theory.

Howard Marvel, the leading exponent of the view that exclusive dealing is used to protect a manufacturer's property rights in distributor investments,⁷¹ argues that rival products will have higher profit margins because the "simplest way" for a manufacturer to charge distributors for its customer-generating investments is to incorporate a charge for the investments in the wholesale price of its goods.⁷² This is what creates the incentive, he claims, for distributors to substitute rival products for the manufacturer's products.

However, when a manufacturer makes distributor investments, this does not affect the manufacturer's marginal costs. Such investments in-

⁷¹ Marvel, *Exclusive Dealing*, *supra* note 54.

⁷² *Id.* at 7.

crease distributor demand and indirectly manufacturer demand. As we shall see, many of the investments that produce these shifts in demand are unlikely to raise the manufacturer's profit-maximizing wholesale price because the investments are aimed at increasing the demand of "marginal consumers" with low reservation values. This is not a problem because a manufacturer need not raise its wholesale price to collect a return on its investments. The manufacturer can earn a return on its investments from increased sales. Of course, this requires that distributors use the manufacturer's investments to sell the manufacturer's products. But if the investments do not increase the manufacturer's wholesale price, it is unclear why distributors have an incentive to switch sales to rival suppliers.

Focusing on an increase in the wholesale price as a way for the manufacturer to charge distributors for supplying valuable assets and as the reason that distributors have an incentive to substitute rival products misses the essential nature of the transaction between the manufacturer and its distributors. Rather than the manufacturer charging distributors for the investments it makes, in many cases freely supplied manufacturer investments are part of the payment by the manufacturer to distributors for the provision of extra distributor promotion. As is shown in what follows, manufacturers often desire more distributor promotional services be supplied than distributors would independently decide to supply. Therefore, manufacturers must contract, implicitly or explicitly, for increased distributor promotion and compensate distributors for these promotional efforts that they would not otherwise undertake.

The examples described in III.A. of manufacturer investments supplied to distributors involve manufacturer investments in distributor promotional assets. For example, *Ryko* involved investments in dealer showroom fixtures and sales training, *Standard Stations* involved gasoline station investments, including subsidized rent, and *Beltone* involved investments in generating customer leads. All of these investments created distributor promotional assets, in the sense that the assets were an important input in the supply of distributor promotion that generates incremental sales.⁷³ By supplying these assets the manufacturer is subsidizing, and thereby compensating, distributors for increased promotion.

Recognizing that manufacturers often compensate distributors for increased promotion broadens the theory of exclusive dealing. As we shall see, there are numerous methods, in addition to direct distributor investments, by which manufacturers compensate distributors. Manufacturer investments are merely one example of a more general—phenomenon—the

⁷³ The subsidization of gasoline stations by refiners is a form of promotional activity because increased outlets generate incremental "impulse sales" from consumers who purchase the product when passing an outlet. *See infra* note 87.

purchase by manufacturers of distributor promotion. Therefore, it is no longer necessary to search for the presence of manufacturer investments to justify the use of an exclusive dealing contract. Distributors have an incentive to “free-ride” on all of these alternative compensation mechanisms by promoting rival products. In particular, since the distributor promotion the manufacturer is purchasing is aimed at marginal consumers, these consumers can be relatively easily switched by the distributor to lower-priced, but higher-margin products. Distributors that are switching consumers, however, are “free-riding” because they are not doing what they are being paid—for—promoting the manufacturer’s products. By preventing switching, exclusive dealing then accomplishes much more than protecting manufacturer investments. Exclusive dealing more generally facilitates manufacturer contracting with distributors for the supply of increased promotional services.

1. Why Manufacturers Purchase Distributor Promotion

Manufacturers purchase distributor promotion because they often desire that distributors supply more promotion than they would otherwise supply absent manufacturer compensation. The fundamental economic insight behind this proposition is that distributors do not take account of the manufacturer’s additional profit on incremental sales when making their decisions regarding how much promotional effort to supply. Consequently, additional distributor promotion that yields profitable incremental sales which more than cover the costs of the promotion may not be undertaken by the distributor. This potential distortion is particularly significant when the manufacturer is selling a differentiated product where the wholesale price is substantially greater than marginal cost. For example, this is the case with cosmetics, pharmaceuticals, or other products with large advertising or R&D costs. In such circumstances, incremental sales may be highly profitable to the manufacturer. However, even if the distributor promotional efforts required to generate these incremental sales are profitable to the manufacturer and distributor taken together, the distributor will not undertake the promotion if its marginal revenues alone will not cover its increased costs of providing the promotion.⁷⁴

In general, if consumers value distributor services more than the costs of supplying such services, competition among distributors will provide consumers with the desired level of such services. However, a further key

⁷⁴ See Benjamin Klein & Kevin M. Murphy, *Vertical Restraints as Contract Enforcement Mechanisms*, 31 J.L. & ECON. 265 (1988) for the original statement of this insufficient distributor promotion problem and the role of various vertical restraints in solving the problem.

economic assumption underlying the insufficient distributor promotion problem is that the incremental sales created by the distributor's promotion are from consumers who are not willing to pay distributors the costs of the promotional services they receive. The essence of promotion is that it is a way to get "marginal consumers," who would not otherwise purchase the manufacturer's product at current market prices, to decide to purchase the product. These incremental sales by "marginal consumers" can be sales by new consumers not now purchasing the product, or sales by existing consumers who will purchase additional quantities of the product after receiving the promotion. In any event, distributor promotional efforts induce incremental sales by raising the reservation values of "marginal consumers" up to the market price. Promotional activity, therefore, can be thought of as the provision of free services that is equivalent to a targeted effective price discount to "marginal consumers."⁷⁵

Because distributor promotion is a form of price discount to "marginal customers," distributors cannot expect to cover the costs of providing promotional services in higher prices charged to the consumers who receive these services. If they attempted to do so, the promotion would be much less effective in generating incremental sales. Distributor competition, therefore, will not lead distributors to undertake the desired (joint manufacturer/distributor profit-maximizing) level of promotion.

This inadequate distributor promotion problem is distinct from the "classic free-riding" problem discussed in *Sylvania*.⁷⁶ The "classic free-riding" problem is created because distributor services are supplied at a zero price. Consumers, therefore, have an incentive to obtain the services free of charge by first visiting a full-service distributor before purchasing the product at a low-service discount distributor. An unaddressed question in this "classic free-riding" analysis is why distributor services are not priced. Full-service distributors can prevent "free-riding" merely by charging consumers for the services they supply. Because distributor promo-

⁷⁵ The effective price discount is received primarily by "marginal consumers" because they consume a relatively large fraction of free distributor promotional services, such as product demonstrations. "Inframarginal consumers," who are already purchasing the product, are likely to avoid the time costs involved in consuming such services. In addition, "marginal consumers" will be more responsive than "inframarginal consumers" to distributor promotional services that consist of free public-type goods, such as displays or shelf space. The increased responsiveness of "marginal consumers" to promotional services is why it is profitable to provide such services at a zero price as an effective price discount. See *id.* at 284-85.

⁷⁶ *Continental TV v. GTE Sylvania*, 433 U.S. 36 (1977). See Benjamin Klein, *Distribution Restrictions Operate By Creating Dealer Profits: Explaining the Use of Maximum Resale Price Maintenance in State Oil v. Kahn*, 7 SUP. CT. ECON. REV. 1, 5-23 (1999) for a discussion of the differences between "classic dealer free-riding" and the more common problem discussed here of distributor "free-riding" on a manufacturer's compensation arrangement for the provision of promotional services.

tional services are almost universally provided at a zero (or even negative) price, this may seem like a strange suggestion. But consumers sometimes pay for product information (e.g., by purchasing *Consumer Reports*) and, if they similarly were willing to pay for distributor promotional services, a charge could be instituted, for example, for the salesperson's time.

The fundamental reason distributors do not charge consumers for their promotional services is because, as described above, distributor promotion often involves the supply of free services as a way of cutting effective prices to "marginal consumers." This is what creates a potential "classic free-riding" problem. However, it is important to recognize that, even if there were no "classic free-riding" problem (for example, if customers were assigned via an exclusive territory to particular distributors so that there was no inter-distributor competition and no possibility of distributors "free-riding" on one another), the nature of promotion implies that distributors still would supply inadequate promotional services from the manufacturer's point of view.

2. Alternative Manufacturer Compensation Arrangements For Increased Distributor Promotional Efforts

Given that distributors often have an insufficient incentive to supply the manufacturer's desired level of promotion, it becomes necessary for the manufacturer to contract for and compensate distributors for their increased promotional efforts. One way in which compensation may occur is for the manufacturer to make direct investments in distributor promotional assets. Alternatively, the manufacturer may merely subsidize the distributor's own promotional investments, such as paying a portion of the distributor's cost of store fixtures or a portion of the distributor's rent. Whether the manufacturer makes the investments itself or subsidizes distributor investments, the effect is the—the same—the manufacturer is compensating distributors with a per unit time payment for supplying more promotion than it would otherwise be profitable for distributors to supply.

Manufacturers also frequently compensate distributors on a per unit sales basis for supplying additional promotional effort. For example, consider the contractual arrangement in *Standard Fashion*.⁷⁷ Standard Fashion, the largest manufacturer of dress patterns with about 40 percent of the market, entered into an exclusive contract with Magrane-Houston Co., a dry-goods retailer in Boston.⁷⁸ Retailer promotion was extremely important in

⁷⁷ *Standard Fashion*, 258 U.S. 346.

⁷⁸ *Id.* at 357. The Supreme Court argued that Standard Fashion's 40 percent market share understated its market power because many small communities had only a single dry-goods retailer. There-

the marketing of dress patterns because Standard Fashion's wholesale price was relatively high compared to its marginal production cost.⁷⁹ Incremental sales, therefore, were likely to be quite profitable for Standard Fashion.

Standard Fashion contracted explicitly with its retailers to supply the desired promotional inputs that would induce these incremental profitable sales.⁸⁰ Specifically, retailers agreed in their Standard Fashion contracts to provide a pattern department at "a prominent position on the ground floor in the store,"⁸¹ a designated "lady attendant" to give "proper attention to the sale" of patterns,⁸² and a minimum inventory level.⁸³ The fact that Standard Fashion found it necessary to contractually specify these required retailer promotional services implies that retailers would not have otherwise voluntarily supplied the full extent of these services. It further implies that retailers must be paid by Standard Fashion for supplying these promotional services.

fore, Standard Fashion's exclusive amounted to a monopoly in many of these communities. *Id.* However, in such local markets it would be the dry-goods store that possessed market power, not Standard Fashion. There would be competition among pattern suppliers to serve such a monopolist dry-goods store, and the decision by the monopolist store to carry dress patterns from a single company would not create any additional market power. Judge Richard Posner argues that if Standard Fashion had market power, it could have used the exclusive in combination with the fact that it sold a very popular full line of patterns that retailers considered essential to prevent or delay the entry of rivals Richard A. Posner, *ANTITRUST LAW* 251-53 (2d ed. 2001). However, as evidence that Standard Fashion's product line was not essential to retailers, *Standard Fashion* involved Magrane-Houston's attempt to substitute Standard's product line for the products of another full-line pattern manufacturer, McCall. Standard Fashion's exclusive dealing contracts, which were only two years in length, were unlikely to be an economic obstacle to such substitution. In fact, the Standard Fashion contract with Magrane-Houston had been running for four years. Standard Fashion sued to enforce its exclusive because Magrane had merely failed to provide the contractually required three-months notice of termination. *Standard Fashion*, 258 U.S. at 351-53.

⁷⁹ Marvel documents that Standard Fashion's wholesale price was at least 50 percent greater than the Sears, Roebuck retail catalog prices, which were obviously above marginal cost. Marvel, *Exclusive Dealing*, *supra* note 54, at 15. This does not imply that Standard Fashion possessed any antitrust market power, merely that Standard Fashion was selling a differentiated product. See Benjamin Klein, *Market Power in Antitrust: Economic Analysis After Kodak*, 3 *SUP. CT. ECON. REV.* 43 (1993) and Benjamin Klein & John Wiley Jr., *Competitive Price Discrimination as an Antitrust Justification for Intellectual Property Refusals to Deal*, 70 *ANTITRUST L.J.* 599 (2003).

⁸⁰ *Standard Fashion*, 258 U.S. at 351-52.

⁸¹ Pls. Ex. 7, R. at 131, *Standard Fashion*, 254 F. 493 (D. Mass. 1918) (Contract, Nov. 25, 1914).

⁸² *Butterick Publ'g Co. v. William G. Fisher*, 203 Mass. 122, 131 (1909). Butterick was the owner of Standard Fashion.

⁸³ Magrane-Houston committed to purchase and have on hand at all times \$1,000 worth of Standard patterns, measured at net invoice prices which were 50 percent of retail prices. This amounted to in excess of 10,000 patterns. Standard Fashion credited Magrane-Houston at 90 percent of its cost for unsold, returned patterns that were exchanged for new stock. *Standard Fashion*, 258 U.S. at 352.

Rather than compensating retailers for their promotional efforts in the form of manufacturer-supplied assets or subsidization of retailer investments, Standard Fashion compensated retailers for their promotional efforts by instituting a marketing arrangement under which its retailers could expect to earn enough to cover their higher costs of supplying the desired level of promotional services. In particular, Standard Fashion set its wholesale prices at 50 percent of retail label prices and contractually required its retailers "not to sell Standard Patterns except at label prices."⁸⁴ Minimum resale price maintenance (in combination with a wholesale price somewhat below what the manufacturer would otherwise charge) creates a per unit sales profit stream for retailers that can cover the desired retailer promotional services. In fact, this is a fairly common way for manufacturers to purchase retailer promotional efforts.⁸⁵

Minimum resale price maintenance is necessary because otherwise the extra manufacturer payment to retailers for promotional services likely would be competed away in lower retail prices by inter-retailer price competition. If the costs of providing extra promotional services are largely per unit time (for example, the rent of a ground floor location, the salary of attendants and extra inventory), even if all retailers were supplying promotional services and not engaging in "classic free-riding," each retailer would have the incentive to lower its price. Consequently, the manufacturer's per unit sale compensation to distributors for supplying extra promotional services would be eliminated.

This analysis explains the use of minimum resale price maintenance in the marketing of many products where a "classic free-riding" explanation does not appear applicable, such as brand name clothing, hair shampoo and vitamins.⁸⁶ These products have substantial manufacturer margins and retailer promotional efforts (most importantly, retail shelf space) are key determinants of the product's aggregate demand.⁸⁷

⁸⁴ *Standard Fashion*, 258 U.S. at 352. A systematic historical survey of exclusive dealing arrangements indicates that resale price maintenance frequently was used in conjunction with exclusives. See Thomas R. Overstreet, Jr., *Resale Price Maintenance: Economic Theories and Empirical Evidence*, BUREAU OF ECON. STAFF REP. TO THE FED. TRADE COMMISSION, 84-101 (1983).

⁸⁵ See Klein & Murphy, *Vertical Restraints as Contract Enforcement Mechanisms*, *supra* note 74. In addition to creating an arrangement where retailers cover the higher costs of supplying desired promotional services, the arrangement also may produce a small profit premium above these higher costs to facilitate self-enforcement of the contractual understanding. Retailer performance is assured by giving retailers a future expected profit stream they will lose if they are terminated by the manufacturer for non-performance.

⁸⁶ See Robert Pitofsky, *Why Dr. Miles Was Right*, 8 REGULATION 27, 29 (1984) for a criticism of "classic free-riding" rationales for resale price maintenance that emphasizes these and other examples.

⁸⁷ Another example of resale price maintenance that is difficult to explain in terms of "classic free-riding" discussed by Pitofsky is the sale of boxed candy. *Id.* (Resale price maintenance cases were brought by the Federal Trade Commission against Barton's Candy and Russell Stover Candies. *In re*

This analysis also explains why slotting fee payments by manufacturers for distributor shelf space are often made on a per unit time basis rather than a per unit sale basis. Manufacturer compensation of distributors for the supply of promotional services on a per unit time basis often is preferable because distributor competition may eliminate per unit sale compensation of distributors. This does not mean that per unit time manufacturer payments will not be passed on to consumers by distributor competition.⁸⁸ Given free entry into distribution, such as grocery retailing, one would expect shelf space payments above the normal rate of return to be competed away. However, we would expect these rents to be competed away by overall price discounts or by targeted price discounts on products that are most likely to get additional customers into the grocery store, not by price discounts on the particular products for which the manufacturer is purchasing shelf space.⁸⁹ This is a benefit of per unit time slotting fees. Given retailer competition, per unit time payments are required so that distributors will receive compensation in equilibrium for supplying the manufacturer with increased promotional services such as shelf space.

Barton's Candy Corp., 79 FTC 101 (Jul. 21, 1971); *In re Russell Stover Candies, Inc.*, 100 FTC 1 (Jul. 1, 1982.) However, the use of resale price maintenance may be explained in these cases as a way to increase the number of retail outlets as a form of distributor promotional activity analogous to increased shelf space that generates incremental "impulse sales." In particular, a significant number of candy customers are likely to be "impulse" buyers, in the sense that they purchase candy only when they pass an outlet. Therefore, consumer demand for the convenience associated with an increased number of outlets, by itself, will not lead to the profit-maximizing number of outlets. An increased number of outlets, supported by an increased retail price margin, is likely to produce profitable incremental sales. Minimum resale price maintenance is required to prevent discount candy outlets from competing for "infra-marginal" consumers, who know they wish to purchase the candy and will shop for it. Without fixed minimum retail prices, one candy outlet could lower price and get these price-sensitive infra-marginal customers, leaving the other candy outlets with reduced sales and profit insufficient to cover the increased costs associated with the desired greater number of outlets. This, in turn, would lead to the exit of outlets and to lower overall manufacturer sales and profits.

⁸⁸ This was the major concern voiced by economists at the Federal Trade Commission Workshop on Slotting Allowances. See *Transcript: Federal Trade Commission Workshop on Slotting Allowances*, May 31, 2000 at <http://www.ftc.gov/bc/slotting/slotting531.pdf> [hereafter Transcript for May 31]; *Transcript: Federal Trade Commission Workshop on Slotting Allowances*, June 1, 2000 at <http://www.ftc.gov/bc/slotting/slotting61.pdf> [hereafter Transcript for June 1]. For example, Steven Salop testified that while wholesale price discounts were likely to get passed on to consumers in the form of lower retail prices lump sum payments were not likely to get passed on, at least in the short run. Transcript for May 31 at 143, 145-46.

⁸⁹ Salop argued that lump sum payments "by making retailing more profitable would have a tendency to lead to greater investment in the retail sector which could lead to more variety and ultimately more competition in the long run and ultimately lower prices." *Id.* at 143. However, there is no reason to believe that competition will only occur on this margin.

In many circumstances there will be difficulties in determining a correct per unit time manufacturer payment for each retailer at each point in time that is unrelated to retailer sales. Retailers differ in size and the desired extra retailer promotional efforts also are likely to depend on retailer size. Therefore, a per unit sale retailer compensation arrangement (or, what is the same thing, per unit time retailer compensation that is related to retailer sales) may be necessary, with the manufacturer controlling inter-retailer price competition.⁹⁰

Whether a manufacturer is making payments to distributors that takes the form of direct investments, per unit time payments (such as a slotting allowance or subsidization of distributor investments) or per unit sale payments in the form of a protected distributor margin, the manufacturer is compensating distributors for the extra promotional efforts they would not otherwise make. Attempting to justify exclusive dealing by focusing solely on whether a manufacturer has made direct investments in distributors leads to a much too narrow search for a particular type of manufacturer compensation of distributors.⁹¹ Distributor-specific manufacturer investments are merely one way distributors are paid by manufacturers for the extra promotional efforts they would not otherwise supply. More generally, no matter how the manufacturer compensates distributors, the role of exclusive dealing, as we shall see, is the—same—to efficiently assure the manufacturer that it will receive the increased distributor promotion it is paying for.

⁹⁰ Resale price maintenance may not be required to prevent inter-retailer price competition from dissipating the manufacturer's per unit sale compensation of retailers for additional promotional efforts when individual retailer price elasticity of demand is not high. This may be the case, for example, when retailers are given exclusive territories or for some products with relatively high search costs. The benefit to the manufacturer of reducing individual retailer demand elasticity may explain why restrictions on price advertising were commonly employed in vertical restraint marketing arrangements. See Overstreet, *Resale Price Maintenance: Economic Theories and Empirical Evidence*, *supra* note 84, at 84-101.

⁹¹ An example of this narrow search for manufacturer investments is Howard Marvel's analysis of exclusive dealing in *Standard Fashion*. See Marvel, *Exclusive Dealing*, *supra* note 54 at 15-18. Since Marvel finds no direct Standard Fashion investments in retailer promotional assets, he searches for other manufacturer investments he believes a retailer may "free-ride" upon in the absence of exclusive dealing and identifies these investments with the manufacturer's creation of the initial dress pattern design. Since a successful design can be copied easily by "free-riding" rival manufacturers, Marvel argues, such rivals will have lower costs and lower wholesale prices than Standard Fashion. Retailers, therefore, will have an incentive to substitute these rival products for the manufacturer's products. *Id.* However, while the copying of patterns is certainly a "free-riding" problem, it is unclear how it is avoided with exclusive dealing. Exclusive dealing, only if collusively agreed to by all manufacturers, may have the effect of preventing limited-line copiers from entering the market. But exclusive dealing will not prevent other full-line manufacturers, or groups of limited-line manufacturers together supplying a full-line of patterns, from entering and copying successful patterns.

3. Exclusivity Prevents Distributor “Free-Riding” on Promotion Compensation Arrangements

To understand why distributors have an incentive to substitute rival products when a manufacturer is compensating them for extra promotional efforts, that is, why the distributor’s profit margin is likely to be higher on rival products, one must consider the nature of the distributor promotion the manufacturer is purchasing. As discussed above, the manufacturer is contracting with distributors to supply promotional services that generate incremental sales by “marginal consumers.” For example, consider *Standard Fashion*. Standard Fashion was buying additional retailer promotional activity (a prominent first floor location with a designated attendant and extra inventory) that it expected would generate incremental sales by “marginal consumers.” However, the increase in Standard Fashion’s demand from this retailer promotional activity was not likely to increase Standard Fashion’s profit-maximizing wholesale price. The profit-maximizing Standard Fashion retail price and, therefore, Standard Fashion’s wholesale price was likely determined by the “infra-marginal” consumers who came into the retailer specifically requesting the Standard Fashion product, not the low reservation demand “marginal consumers” the retailer’s promotional efforts were aimed at.⁹²

The reason an incentive is created for retailers to promote the sale of rival products in these circumstances is because many of the “marginal consumers” the manufacturer is aiming at not only had relatively low reservation demands for the Standard Fashion product, but also likely had no strong brand preference. Therefore, these “marginal consumers” would be willing to purchase a rival, low brand name product in response to the retailer’s promotional efforts. The retailer’s profit margin is higher on such low brand name products because it can purchase them at wholesale prices much closer to marginal cost. Suppliers of low brand name products face highly elastic demand curves because retailers can play off alternative, essentially perfectly substitutable, rival suppliers of such low brand name products. Retailers, therefore, have the ability both to set lower retail prices for such low brand name products and also to earn a greater profit margin.⁹³

⁹² Standard Fashion’s wholesale price would be reduced if Standard compensated retailers for their promotional efforts with a per unit sale payment, rather than a per unit time payment. However, this would not affect the final retail profit maximizing price. See Klein & Murphy, *Vertical Restraints as Contract Enforcement Mechanisms*, *supra* note 74.

⁹³ To avoid the extra retailer profit margin on the low brand name product from being competed away by inter-retailer competition, the “free-riding” retailer may sometimes ask the rival supplier to provide the product under a unique name not used by other retailers, such as a store brand.

Retailers that are substituting rival low brand name products for the manufacturer's products are "free-riding," not in the "classic free-riding" *Sylvania* sense, but in the sense that they are "free-riding" on the manufacturer's promotion compensation arrangement. They are using the extra promotion paid for by the manufacturer to sell lower wholesale-priced, higher retailer profit margin products.

In addition to using promotional resources paid for by a manufacturer to promote lower-priced rival products to consumers that have no brand preference, in some circumstances a retailer may have an incentive to sell a rival high brand name product that has the same wholesale price because the retailer has lower costs of doing so. For example, a salesperson will not find it in its interests to make the extra promotional effort to extol the advantages of the manufacturer's product when a customer asks for a rival brand. It is more economic for the salesperson to save the costs of the extra time and effort that may lead to a sale of the manufacturer's product and, instead, merely sell the rival brand. Because of the lower marginal selling costs, there is a higher profit margin on the rival brand sale.

If the manufacturer could contractually specify the desired retailer promotional effort, there would be no need for exclusive dealing to solve these problems. If, for example, retailer promotion consisted solely of particular retail shelf space or other specific retailer promotion that could be precisely defined, a contract could be written for retailer supply of these promotional efforts. However, some elements of retailer promotion, such as point-of-sale efforts, are not easily contractually specified and cheaply monitored and enforced. For example, Standard Fashion contractually specified the supply of some particular retailer promotional assets, such as a prominent ground floor location and sales attendants. But without an exclusive, these assets would not necessarily have been used to promote the sale of Standard's products.

In general, distributors have an incentive to "cheat" on the incomplete contractual arrangement for the supply of promotion by switching their promotional efforts to rival, higher profit margin products. When the manufacturer compensates distributors by making direct distributor investments or per unit time payments to distributors in return for increased promotional efforts, the incentive for distributors to "free-ride" by substituting a rival product, as described above, is obvious. The distributor is accepting payments to promote the manufacturer's product and then is not doing so. The distributor is in a sense selling its promotional efforts twice.

When the manufacturer makes a per unit sale payment to distributors for increased promotion, distributor "free-riding" may not be as obvious. Since the manufacturer's compensation for the provision of distributor promotional services is a contingent payment, it may appear that the dis-

tributor is not selling its promotion twice. When the distributor switches consumers to another brand, the distributor is paid less. However, distributors operating under such a per unit sale contractual arrangement with the manufacturer for the provision of promotional services have an incentive to substitute rival brands because they are compensated for their desired promotion efforts on the basis of a profit premium they earn on their *total* sales of the manufacturer's products, not on the difficult to measure incremental sales produced by their promotional efforts. Therefore, although the manufacturer may be able to fairly easily check if the distributor is providing the contractually mandated promotional inputs, such as a prominent first-floor location, the distributor will have an incentive to use these promotional inputs to make incremental sales of higher profit margin rival products. The distributor continues to receive most of the manufacturer's compensation on infra-marginal sales, yet uses its promotional assets to sell more profitable rival products. The distributor is "free-riding" on the manufacturer's compensation arrangement for distributor promotion.⁹⁴

Of course, we are not likely to observe such distributor "free-riding" on a systematic basis. Manufacturers will have rational expectations and, if they cannot control distributor "free-riding," they will reduce what they are willing to pay for distributor promotion. If distributors cannot efficiently commit to supply the desired promotion, manufacturers will not demand it. Exclusive dealing is a way of increasing what distributors will receive for promotion by facilitating the contract between the manufacturer and distributor for desired promotion. By contractually controlling the ability of distributors to substitute away from the manufacturer's products, the manufacturer is assured it will more likely receive the promotional effort the distributor is promising and that it is paying for.

The manufacturer still must monitor distributor performance and self-enforce its implicit contractual understanding with distributors regarding the supply of promotional efforts. In particular, the manufacturer must monitor distributor efforts along noncontractible dimensions, as well as monitor the exclusive and other contracted elements of promotional performance. However, exclusive dealing, by contractually controlling distributor non-performance, makes it more likely, for any given manufacturer

⁹⁴ Manufacturers may sometimes attempt to pay distributors purely on incremental sales. However, in addition to administrative problems in setting and revising individual distributor sales goals and potential Robinson-Patman problems, significantly lower wholesale prices or large bonuses on incremental sales may create inter-distributor arbitrage problems, along with the possibility of greater than optimal inter-distributor competition and a smaller than optimal number of distributors. See *supra* note 87.

monitoring and premium payment cost, that the contractual relationship will be self-enforcing.⁹⁵

This analysis of how exclusive dealing encourages increased distributor promotion provides the economic foundation for the accepted efficiency rationale for exclusive dealing as a way for a manufacturer to create distributors with “undivided loyalty” who will focus their selling efforts on its products. For example, in *Joyce Beverages*⁹⁶ Royal Crown Cola, a firm with only a 5 percent share of U.S. cola sales,⁹⁷ required its bottler distributors to use their “best efforts . . . to achieve maximum distribution and sale” of Royal Crown Cola beverages, including agreeing not to carry any other cola brand.⁹⁸ The court concluded that this exclusive distribution contract increased rather than inhibited competition because it “insures that the bottler devotes undivided loyalty to its particular brand and that it competes vigorously against all competing brands.”⁹⁹

Although an “undivided loyalty” rationale for exclusive dealing is intuitively appealing and has been adopted in a number of decisions,¹⁰⁰ the economic basis for an “undivided loyalty” rationale is not obvious. In particular, a systematic economic explanation of why an exclusive is necessary to generate the desired level of distributor promotion is not presented in either case law or the academic literature.¹⁰¹ Howard Marvel convincingly shows that an exclusive which creates “undivided loyalty” certainly does not solve the standard economic problem of inadequate distributor promotion caused by “classic free-riding.”¹⁰² Distributors who handle only one

⁹⁵ For a general analysis of the complementarity of court-enforced explicit contract terms and self-enforced implicit contractual understandings, see Benjamin Klein, *Why Hold-Ups Occur: The Self-Enforcing Range of Contractual Relationships*, 34 *ECON. INQUIRY* 444 (1996) and Benjamin Klein, *The Role of Incomplete Contracts In Self-Enforcing Relationships*, 92 *REVUE D'ECONOMIE INDUSTRIELLE* 67 (2000).

⁹⁶ *Joyce Beverages v. Royal Crown Cola Co.*, 555 F. Supp. 271 (S.D.N.Y. 1983).

⁹⁷ *Id.* at 273.

⁹⁸ *Id.* at 273-74.

⁹⁹ *Id.* at 278.

¹⁰⁰ See also *Hendricks Music Co. v. Steinway, Inc.*, 689 F.Supp. 1501, 1514, 1545-48 (N.D. Ill. 1988) (“[I]t is perfectly legitimate and, in fact, procompetitive, for manufacturers to insist that their dealers devote undivided loyalty to their products and not to those of their competitors.”); *Roland Mach. Co.*, 749 F.2d at 395 (a dealer that accepts an exclusive “indicates his commitment to pushing that brand; he doesn’t have divided loyalties.” citing *Sulmeyer v. Coca-Cola Co.*, 515 F.2d 835, 840 n.2 (5th Cir. 1975)).

¹⁰¹ The Seventh Circuit in *Roland Machinery* claims an exclusive gives the dealer an increased incentive to promote because the dealer has “nothing to fall back on” if the manufacturer’s product does not do well. *Roland Mach. Co.*, 749 F.2d at 395. However, this does not imply that the dealer will not adequately promote the product absent an exclusive.

¹⁰² Marvel, *Exclusive Dealing*, *supra* note 54, at 3-5.

brand still have an incentive not to supply services and to “free-ride” on full-service distributors.

This reasoning, which rejects exclusive dealing as a way to correct inadequate distributor promotion, assumes that the only reason distributors may have an insufficient incentive to provide promotional services is because of inter-distributor “classic free-riding.” However, as we have seen, exclusive dealing that generates “undivided loyalty” may make economic sense as a way to prevent distributors from engaging in another type of “free riding”—distributor “free-riding”—on the manufacturer’s compensation arrangement for the provision of extra distributor promotion. In particular, exclusive dealing may facilitate contracting for distributor promotional efforts by preventing distributors from using their assets and sales personnel, paid for directly or indirectly by the manufacturer, to promote a rival brand. In the case of Royal Crown Cola bottlers, for example, the Royal Crown payment for extra promotional efforts took the form, in part, of the grant of a valuable exclusive territory.¹⁰³ Exclusive dealing assured Royal Crown that its bottlers would use the promotional assets and sales personnel it paid for to “compete for shelf space, display racks, promotional rotations and the placement of feature advertising”¹⁰⁴ solely for the Royal Crown Cola brand.

The danger of attempting to place the entire economic analysis of insufficient distributor promotion within the “classic free-riding” pigeonhole is illustrated in *Dentsply*,¹⁰⁵ where the court rejected Dentsply’s “undivided loyalty” rationale for exclusive dealing. The court concluded that “The ‘focus dealer services’ rationale is not a valid justification for using exclusive dealing . . . because dealers have every incentive on their own to make sure that their level of service . . . does not suffer.”¹⁰⁶ The court’s reasoning does not recognize that, even in the absence of “classic free-riding,” dealer incentives may be insufficient to generate the desired level of promotional efforts.¹⁰⁷

¹⁰³ *Id.*

¹⁰⁴ *Joyce Beverages*, 555 F.Supp. at 275.

¹⁰⁵ *Dentsply*, 277 F. Supp. 2d 387.

¹⁰⁶ *Id.* at 441. The court noted that Dentsply presented this “focus dealers” defense in an interrogatory response and in the testimony of a former Dentsply executive, not with testimony of its economic expert, Professor Howard Marvel. The court recognized that “Prof. Marvel has not endorsed this particular rationale for exclusive dealing To the contrary, he stated in his 1982 paper that enhancing dealer services cannot be the justification for exclusive dealing.” *Id.* Instead of endorsing the “focus dealers” rationale, Professor Marvel hypothesized that exclusive dealing prevented distributor free-riding on Dentsply promotional investments, which the court found pretextual. *Id.* at 455.

¹⁰⁷ Although the court did not find any valid procompetitive rationale for Dentsply’s exclusive dealing contracts, it rejected the Justice Department’s claim that the exclusive dealing contracts were anticompetitive “because direct distribution is viable, non-Dentsply dealers are available, and Dentsply dealers may be converted at any time.” *Id.* at 453.

Exclusive dealing is not a costless solution to the problem of preventing distributors from “free-riding” on the manufacturer compensation arrangement for distributor promotion. A consequence of exclusive dealing contracts is that consumers will face somewhat reduced variety at individual distributors. But if distributors are operating in competitive industries, distributors will have the correct incentive to make an appropriate trade-off between carrying a reduced variety with a lower wholesale price (and/or other manufacturer payment) versus an increased variety with a higher wholesale price. Since there is competition at the distributor level, each distributor’s decision will depend on the value consumers place on variety versus lower retail prices. If, in fact, consumers prefer greater selection at higher prices, competition among distributors will provide it to them. But if consumers do not have a significant preference for variety, exclusive dealing may be an efficient way to contract for distributor promotional effort that maximizes the return received by distributors and, therefore, the indirect benefit received by consumers.¹⁰⁸

4. Exclusivity Maximizes What the Distributor Receives For the Delivery of Its Customers

The above analysis indicates that exclusive dealing may be used when a manufacturer’s contract with distributors for the supply of promotion is incomplete. Under these circumstances, distributors have an incentive to take advantage of the contractual incompleteness to switch their promotional efforts to rival products. An exclusive prevents such “free-riding” on the manufacturer’s compensation arrangement for distributor promotion. By permitting distributors to contractually commit to provide their agreed upon promotional efforts and not to “free-ride,” an exclusive thereby maximizes the return received by distributors for their promotion. How-

¹⁰⁸ For some products where consumers’ demand for variety implies that a full exclusive would not be efficient, distributors may be able to obtain the best of both worlds by receiving manufacturer payments or wholesale price discounts for designating a manufacturer as a “category manager” or “category captain.” The “category manager” features its products and makes recommendations to the distributor on quantities and types of rival products that also should be carried. In *Conwood Co. v. United States Tobacco Co.*, 290 F.3d 768 (6th Cir. 2002), United States Tobacco Co. was found to have abused its position as category manager in a number of ways, including sometimes removing competitors’ display racks without the permission of the retailer. In general, we would expect a self-enforcing mechanism (manufacturer termination, with the loss of future rents) to protect distributors against manufacturer abuses of their category manager designation. Although category management is less restrictive than an outright exclusive, and therefore the antitrust standard should be weaker, *Conwood* appears to impose additional legal duties on a category manager to act fairly in protecting rivals’ ability to compete. In particular, the Court found “the manner in which it [USTC] used its position as a monopolist providing category management services” to be anticompetitive. *Conwood*, 290 F.3d at 786-87.

ever, an exclusive also may maximize the return received by distributors for promotion when the contract governing the supply of distributor promotion is complete and there is no potential for “free-riding” on the manufacturer’s compensation arrangement.

For example, in contrast to the cases described above where there were non-contractually specified elements of distributor promotional efforts, assume that distributor promotion consisted entirely of clearly specified and easily monitored characteristics, such as the amount of distributor shelf space. The distributor, therefore, is assumed not to have the ability to take advantage of the manufacturer compensation arrangement by switching promotion to a rival product. The manufacturer purchases, for example, a certain number of linear feet of shelf space, which cannot be used to sell any other product.¹⁰⁹ However, even under these conditions, exclusive dealing may serve to increase the value of the distributor’s promotional efforts.

In many circumstances distributors have established customer relationships (based on the distributor’s reputation, locational advantage or other factors). Rather than thinking of distributors as merely passive transmitters of ultimate demand by consumers for alternative manufacturers’ products, distributors in these cases may more usefully be thought of as “possessing” a group of customers for whom they are choosing a manufacturer or a number of potential manufacturers. Manufacturers then are competing for a distributor’s customers when they compete for a distribution contract, for example, when they contract with distributors for shelf space.

In contrast to the analysis above where distributors will supply inadequate promotional efforts such as shelf space without manufacturer compensation, distributors will not necessarily supply less than the desired aggregate amount of promotion in these cases. Since distributors “possess” a group of customers, competition between manufacturers is for an increased relative amount of distributor promotion. In particular, a distributor’s decision to feature a manufacturer’s product (by increasing the manufacturer’s shelf space at the expense of other manufacturers’ shelf space) creates incremental profitable sales for the featured manufacturer. The provision of featured shelf space can be thought of as essentially delivering a fraction of the distributor’s customers to the manufacturer. Featured shelf space, therefore, is what is valuable to manufacturers.

The rents earned by a distributor for its shelf space can be thought of as a payment for the distributor’s promotional effort. The question is: When can a distributor increase the return on its promotion by agreeing to provide all or most of its shelf space to one manufacturer? Consider, for example,

¹⁰⁹ Other elements of the promotion, such as the location of the shelf space, as well as the distributor’s commitment to carry sufficient inventories and to frequently re-stock the shelves, are assumed away.

the sale of spices in grocery stores.¹¹⁰ For the overwhelming number of consumers, the particular brands of spices carried by a grocery are not likely to be a major determinant of where they decide to shop. In this sense, the grocery is delivering its consumers to a particular spice manufacturer when it decides to carry a spice brand on its shelves. We can assume that the contract between a spice manufacturer and a grocery store for specific grocery shelf space (paid for by the manufacturer with either a per unit time or per unit output compensation arrangement) is complete. Therefore, an exclusive is not necessary to prevent grocery “free-riding” on the manufacturer compensation arrangement because such “free-riding” cannot occur. However, if a grocery store agrees to grant a de facto exclusive and feature a single spice brand, it may be able to increase the total amount it receives (in the form of substantially larger price discounts and/or other manufacturer payments) for its shelf space.

This effect has nothing to do with the anticompetitive foreclosure of rivals. Instead, it has to do with a grocery’s supply of promotional services. Grocery consumers may have preferences for different spice brands when all alternatives are available on the grocery shelf. However, in this case the grocery is not supplying any promotional services. When the grocery informs the spice manufacturers that it will feature only one brand, it then is offering to supply promotion. The grocery and indirectly its consumers benefit from this shelf space competition because the grocery now has the ability to bargain more effectively since it is acting as an agent for all its consumers. By deciding to feature only one brand, the grocery has made alternative spice brands, in effect, perfect substitutes for one another before they are placed on the shelf.¹¹¹ Because the grocery is essentially offering all its customers as a group to competing manufacturers, the elasticity of demand faced by each spice manufacturer increases. Each spice manufacturer knows it can get all or most of the grocery’s customers if it lowers the price it offers to the grocery a little bit and obtains the featured shelf space. This drives the wholesale price down compared to if the spice manufacturers were on the shelf competing for individual customers. And since there is competition in grocery retailing, grocery consumers are likely to be better off with reduced spice brand variety and lower overall prices.

This analysis also may explain the use of exclusives in Microsoft and Netscape’s competition for browser distribution by Internet access providers. Given the improvements made in browser software by Microsoft and

¹¹⁰ See Settlement Agreement, Fed. Trade Comm’n v. McCormick (FTC File No. 961-0050) (Feb. 3, 2000).

¹¹¹ I am indebted to Kevin Murphy for discussion of this difference between *ex ante* manufacturer competition for distributor shelf space and *ex post* manufacturer competition for consumer purchases of products that are on the distributor’s shelf.

Netscape, it made sense for Internet access providers to integrate Internet Explorer and/or Navigator browser software into their access software. For example, America Online, the largest Internet access provider, in 1996 planned to feature either Internet Explorer or Navigator in its access software.¹¹² Featuring one browser made economic sense because many subscribers to an Internet access provider such as America Online will use whatever browser software is chosen as the featured browser. Therefore, America Online's commitment to deliver most of its subscribers to the winning browser software bidder would increase the competition between Microsoft and Netscape for the America Online account.

After Microsoft's Internet Explorer browser software was integrated into America Online's Internet access software, most new subscribers accepted Internet Explorer. However, America Online limited the costs of reduced variety associated with its de facto exclusive browser contract by permitting the few subscribers that preferred Navigator to Internet Explorer to explicitly request and receive Navigator.¹¹³ In this sense the contract was not strictly an exclusive; the contract was an exclusive promotion contract. America Online agreed not to promote any browser other than Internet Explorer for two years and contractually guaranteed that a minimum of 85 percent of new subscribers would use Internet Explorer technology.¹¹⁴

Similar to what was described above with regard to grocery distribution by spice manufacturers, this contract likely maximized the payment America Online (and indirectly America Online's subscribers) received for supplying all its promotional efforts to one browser software supplier. Internet access providers could expect to receive more from alternative browser suppliers by acting as an agent for all their subscribers and committing to deliver all their subscribers as a group to the winning bidder. By forcing Microsoft and Netscape to compete for all its subscribers as a group, America Online and other Internet access providers increased the competition between Microsoft and Netscape by, in effect, increasing the elasticity of demand facing each of them. This maximized the return received by America Online for the delivery of their subscriber base to the winning bidder.

If Microsoft had compensated Internet access providers for browser distribution on a purely per subscriber contingent basis, without any Internet access provider exclusive promotion commitment, the result in terms of the market success of Internet Explorer very likely would have been identical. Microsoft likely would have entered contingent per subscriber distribu-

¹¹² *Microsoft*, 84 F. Supp. 2d at 82.

¹¹³ *Microsoft*, 253 F.3d at 68.

¹¹⁴ *Id.* at 68. Microsoft entered similar exclusive promotion contracts with all other leading Internet access providers, who generally committed to keep shipments of Navigator below 25 percent. *Id.*

tion contracts with all available Internet access providers, and most subscribers would have ended up using Internet Explorer. The fundamental determinant of Microsoft's success in the Internet access provider channel was the amount it was willing to pay for browser distribution, not the form of its distribution contracts. In fact, this analysis suggests that it may have cost Microsoft less if it entered per subscriber distribution contracts than its exclusive promotion contracts. Internet access providers offered their subscribers to Microsoft on an exclusive basis because delivering their subscribers as a group increased the return they received for making their subscriber base available. Internet access provider competition could then be expected to pass at least some of this increased return on to their subscribers.

CONCLUSION

We should, in general, be reluctant to adopt antitrust rules that artificially short-circuit the normal process of competition for distribution. However, determining what the normal competitive process consists of often is a difficult task.

Whether any particular act of a monopolist is exclusionary, rather than merely a form of vigorous competition, can be difficult to discern: the means of illicit exclusion, like the means of legitimate competition, are myriad. The challenge for an antitrust court lies in stating a general rule for distinguishing between exclusionary acts, which reduce social welfare, and competitive acts, which increase it.¹¹⁵

Permitting firms to engage freely in competition for distribution with reduced prices or, equivalently, with direct payments to distributors is a reasonable first step in formulating such a general rule that distinguishes exclusionary from competitive actions. Firms that achieve a large share of distribution in this way should almost universally be considered as "competing on the merits." Since the indirect benefits consumers receive from price competition for distribution are analogous to the direct benefits consumers receive from product price competition, the antitrust standards for predatory distributor competition should be similar to the high standards now used for illegal predatory product price competition.¹¹⁶

This is fully consistent with *Microsoft*, where neither the district court nor the D.C. Circuit accepted the primary anticompetitive claims of the

¹¹⁵ *Id.* at 58.

¹¹⁶ See *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574 (1986); *Atlantic Richfield Co. v. USA Petroleum Co.*, 495 U.S. 328 (1990); *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209 (1993).

government that Microsoft had engaged in predatory competition by offering overly favorable terms to Internet access providers.¹¹⁷ The Court recognized that even negative browser software prices were a permissible result of the competitive process.¹¹⁸ What the Court found to be an antitrust violation was not the excessively large amount Microsoft paid for distribution, but the exclusive form of its distribution contracts.¹¹⁹

This paper demonstrates that there is a much broader range of legitimate efficiency justifications for exclusive contracts beyond the commonly recognized rationale that exclusives protect a manufacturer's property rights on its distributor investments. Once one recognizes that distributors generally will not have the appropriate incentive to supply promotional services, it follows that an implicit or explicit contract must be entered between a manufacturer and its distributors for the supply of distributor promotion. Whatever the particular form of this contract and the specific mechanism by which manufacturers compensate their distributors for supplying increased promotion, a potential distributor "free-riding" problem often is created. This problem exists because the distributor promotion contract is generally incomplete and the desired promotional efforts are aimed at consumers who have low reservation demands for the manufacturer's product and, therefore, may be easily switched to a non-brand name alternative in violation of the contractual understanding. Exclusive dealing may be an efficient way to avoid this distributor "free-riding" problem, contractually assuring manufacturers that they will receive the promotional efforts they are paying for and maximizing the compensation received by distributors for their promotional efforts. By getting the best deal for themselves, distributors also obtain the best deal for consumers.

Finally, it is important to emphasize that, although the efficiencies of exclusive contracts may sometimes be difficult to understand in specific cases, one must avoid the tendency, recently highlighted by Tim Muris, of condemning conduct one cannot explain without also finding an anticompetitive effect.¹²⁰ This danger becomes particularly severe when the question is formulated in terms of whether a firm's conduct has placed an unnecessary burden on competitors. Most competition for distribution disadvantages competitors. However, competition for distribution is part of the normal competitive process that benefits consumers. While the efficiency justification for a particular exclusive distribution contract may sometimes not be obvious, the requirement of anticompetitive effect should continue to

¹¹⁷ *Microsoft*, 253 F.3d at 68.

¹¹⁸ *Id.*

¹¹⁹ *Id.* at 68-71.

¹²⁰ Timothy J. Muris, *The FTC and The Law of Monopolization*, 67 ANTITRUST L.J. 693 (2000).

be a minimum safeguard in all cases of alleged exclusionary contracts that appear to "raise rivals' costs."