The Sedona Conference Journal

Volume 3 2002

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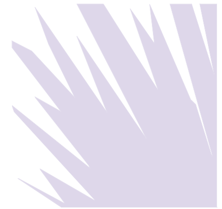
Jonathan M. Jacobson



Recommended Citation: Jonathan M. Jacobson, *Market Power, Consumer Harm & Exclusive Dealing with Distributors,* 3 SEDONA CONF. J. 23 (2002).

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MARKET POWER, CONSUMER HARM & EXCLUSIVE DEALING WITH DISTRIBUTORS

*Jonathan M. Jacobson**
Akin, Gump, Strauss, Hauer & Feld, L.L.P.
New York, New York

The last few years have given rise to a number of significant cases involving suppliers' exclusive dealing arrangements with distributors. Some of these, including the Justice Department's case against *Dentsply*,[1] have been litigated as traditional vertical exclusive dealing cases under section 1 of the Sherman Act.[2] Others, most prominently including *Microsoft*,[3] addressed exclusive dealing in the context of monopolization claims under section 2.[4] One, *PepsiCo v. Coca-Cola Co.*,[5] was based on the comparatively novel approach of confining the relevant product market to sales through a subset of the distributors with whom the exclusive arrangements had been made. Yet another, *United States v. Visa USA,*[6] involved a set of matching horizontal restraints where the defense attempted to use vertical exclusive dealing standards to avoid condemnation.

Although the factual contexts vary widely, and the courts have reached different results based on those varied facts, two consistent themes emerge. First, proof of real power in a real market is an essential component of any kind of challenge to exclusive dealing. But, second, if the exclusive dealing arrangements have been proven in fact to allow the defendant to raise prices, restrict output, or otherwise exercise significant market power, that – in the absence of countervailing efficiencies – is a sufficient showing of consumer harm to warrant a determination of illegality.

The discussion below focuses on the decisions in *Pepsi*, *Visa*, *Microsoft*, and *Dentsply,* and then turns to more general questions of market power, consumer harm, and antitrust policy in the context of exclusive dealing arrangements with distributors.

I. THE RECENT CASES

PepsiCo v. Coca-Cola

Background. The *PepsiCo* case centered on the fountain syrup channel of the soft drink industry. Fountain syrup is sold to restaurants, movie theatres, sports venues, convenience stores, and other retail outlets. It is then mixed with carbonated water at the point of sale and served to consumers for on-premise consumption. Fountain sales have grown rapidly for many years, and now represent about 23 percent of all soft drink sales.

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* As a disclaimer, Mr. Jacobson represented The Coca-Cola Company in *PepsiCo v. Coca-Cola Co.* and American Express Company in *United States v. Visa & MasterCard,* both of which are addressed in the text below. The views expressed herein are entirely his own and do not represent the views of these or any other client.

1 *United States v. Dentsply, Inc.,* 2001-1 Trade Cas. (CCH) ¶ 73,247 (D. Del. 2001).

2 *See also CDC Technologies v. IDEXX Industries,* 186 F.3d 74 (2d Cir. 1999); *Bepco, Inc. v. Allied-Signal, Inc.,* 106 F. Supp. 2d 243 (M.D.N.C. 2000); *Minnesota Mining & Manufacturing Co. v. Appleton Papers, Inc.,* 35 F. Supp. 2d 1138 (D. Minn. 1999). Exclusive dealing is often litigated under section 3 of the Clayton Act when the transaction involves "goods . . . or other commodities," but for simplicity the discussion here will be limited to the Sherman Act. Whatever substantive differences may exist between the two statutes in terms of competitive impact are difficult to discern. *See generally* ABA ANTITRUST SECTION, ANTITRUST LAW DEVELOPMENTS 214-25 (4th ed. 1997).

3 *United States v. Microsoft Corp.,* 253 F.3d 34 (D.C. Cir.) (en banc), *cert. denied,* 70 U.S.L.W. 3107 (U.S. 2001) (No. 01-236).

4 *See also Western Parcel Express v. UPS,* 190 F.3d 974 (9th Cir. 1999).

5 114 F. Supp. 2d 243 (S.D.N.Y. 2000), *appeal pending,* No. 00-9342 (2d Cir., argued Oct. 11, 2001).

6 2001-2 Trade Cas. (CCH) ¶ 74,440 (S.D.N.Y. Oct. 9, 2001).

In 1899, when Coca-Cola licensed rights to its bottle/can business to independent bottlers operating in exclusive territories, it retained for itself all rights to the fountain business. Pepsi chose a different approach. It licensed all rights, including fountain, to its bottlers, thus sharing with them in the equity ownership of Pepsi-Cola fountain rights. These century-old decisions continue to have a major impact on the business today. Sole ownership of its fountain business has led Coca-Cola to invest in and develop the business far more aggressively than Pepsi; and Coca-Cola's national focus has given it an important edge in competing for national restaurant chain business. Chain business expanded dramatically over the last three to four decades, and now represents the substantial majority of all fountain sales. Pepsi's disadvantage at these accounts was exacerbated significantly in the 1980s by its acquisitions of Taco Bell, KFC, and Pizza Hut, as other large chains had no interest in doing business with their largest restaurant competitor. As a result of its lead in chain business and its greater development of the fountain channel overall, Coke has generally outsold Pepsi in fountain by roughly three to one and maintains that lead today.

The differences between fountain ownership rights in the Coke and Pepsi systems led to a significant difference in their methods of fountain distribution. While Pepsi relied entirely on its bottling system, Coca-Cola used independent wholesalers (who had no exclusive territories) and used no bottlers at all until 1960. Starting in the 1970s, each of the very large restaurant chains began using consolidated distribution through foodservice distributors (FSDs) to deliver most of the restaurant's supplies on a single truck – including meat, sauce, utensils, and the like. Coca-Cola appointed the major FSDs as Coke wholesalers, allowing deliveries of fountain syrup to be consolidated into the deliveries of other restaurant supplies. Pepsi, however, stuck with its bottling system, in part because its bottlers viewed FSD delivery as an incursion on their exclusive franchise territory rights. The one area where the Coke and Pepsi systems were identical, however, was cola exclusivity. Just as Pepsi bottlers were of course prohibited from carrying Coca-Cola products, Coke prohibited all its distributors – bottlers, wholesalers, and FSDs – from carrying any competing cola products, especially Pepsi.

Coke's exclusive arrangements with the FSDs posed no issue for decades. In 1997, however, Pepsi sought to reinvigorate its fountain business. It sold its restaurants and, significantly for purposes of the ensuing litigation, revised most of its bottler agreements to permit FSD delivery for the first time. Pepsi's attempts to get FSDs to carry Pepsi products, however, ran into problems. Coca-Cola enforced the "Conflict-of-Interest" clauses in its distributor agreements, which precluded the FSDs from carrying competing colas. The vast majority of the FSDs unsurprisingly elected to stay with Coke. Pepsi compounded its problems by refusing to bid against Coke for exclusive distributor business, due in part to its bottlers' fears that FSDs committed to Pepsi would try to encourage Pepsi accounts to switch their delivery business away from the bottlers. Nor did Pepsi make any effort to acquire FSDs. In fact, Pepsi had owned the second-largest FSD in the country, but chose to sell it (after its restaurants had been sold) a few months before the litigation began.

Soon after a few FSDs communicated to Pepsi their decision to remain with Coke rather than risk termination, Pepsi decided to sue. But the suit faced problems. A recent Ninth Circuit decision, *Omega Environmental v. Gilbarco, Inc.,*[7] had made challenges to exclusive dealing arrangements with distributors much more difficult, upholding arrangements foreclosing 38 percent of the market imposed by a firm with a 55 percent market share. In addition, Pepsi recognized that all of Coke's agreements with the FSDs were terminable at will on 10 days notice. Many courts, including the Second Circuit, had

7 127 F.3d 1157 (9th Cir. 1997).

all but ruled out section 1 exclusive dealing claims in cases involving short-term arrangements of 12 months or less.[8]

Pepsi sought to overcome these hurdles by styling the case as one for actual or attempted monopolization under section 2 of the Sherman Act, confining the market to fountain syrup sales made through FSDs only. This, at least in theory, made the foreclosure percentages much higher and allowed Pepsi to rely on section 2 refusal to deal cases, especially *Lorain Journal Co. v. United States,*[9] as an answer to the argument that the agreements were terminable on short notice. And, at least initially, Pepsi's strategy worked. Coke moved to dismiss the complaint based on the inadequacy of the relevant market and the short-term nature of the agreements, but the district court denied the motion in all respects.[10] Relying on cases like *Staples*[11] and *Cardinal Health*,[12] the district court held that a relevant market could be limited to one method of product distribution if it could be shown, as Pepsi alleged, that other methods were not acceptable substitutes.

The theory that Pepsi came up with in its attempt to prove both the relevant market and market power was clever. Pepsi argued that FSD delivery was not only preferred by many chain restaurant customers; it also cost Pepsi less to deliver.[13] Denial of access to FSD delivery, therefore, raised Pepsi's costs. Since Coke and Pepsi were the only credible rivals for fountain sales to major chain restaurants, raising Pepsi's costs in this manner allowed Coke to increase prices by an equivalent amount. This price effect, Pepsi said, proved the relevant market – under Pepsi's theory, the price effect qualified as a significant nontransitory price increase under the *Merger Guidelines*.[14] It also proved market power – Coke was able, Pepsi said, to maintain prices at supracompetitive levels. George Hay, as testifying expert, attested that the theory was sound. But coming up with a viable economic theory and getting past a motion to dismiss was one thing. That got Pepsi plenty of discovery – 136 depositions, two million pages of documents, and megabytes of computer data – but Pepsi also needed hard supporting evidence, particularly on market definition and market power. It is there that Pepsi ultimately fell far short.

Rejecting Pepsi's argument that it could prove market power directly and, therefore, need not establish a relevant market, the district court ruled that proof of a valid product market was indeed an indispensable element of Pepsi's claims both under section 1 and section 2 of the Sherman Act. Evaluating the parties' extensive evidentiary submissions, the court concluded that Pepsi's proof of a product market limited to fountain syrup distributed by FSDs was legally insufficient. The court accordingly granted summary judgment, dismissing the case in its entirety.[15]

Market definition. The district court determined that FSD delivery, however desirable, was in no way indispensable. Some 70 customers were deposed or provided declarations. Not one said that it ever chose Coke over Pepsi because of FSD distribution. On the contrary, each said that delivery method was just one of many factors considered. Though the degree of importance attached to FSD delivery varied widely, none of the customer witnesses ever found it the most important of the factors considered. All said they considered Pepsi a viable competitor irrespective of the method of delivery. And in a

8 *E.g., id.* at 1163-64; *Balaklaw v. Lovell,* 14 F.3d 793, 799 (2d Cir. 1994); *Paddock Publications v. Chicago Tribune Co.,* 103 F.3d 42, 44 (7th Cir. 1996); *Roland Machinery Co. v. Dresser Indus.,* 749 F.2d 380, 395 (7th Cir. 1984).

9 342 U.S. 143 (1951).

10 *PepsiCo, Inc. v. Coca-Cola Co.,* 1998-2 Trade Cas. (CCH) ¶ 72,257 (S.D.N.Y. 1998).

11 *FTC v. Staples, Inc.,* 970 F. Supp. 1066 (D.D.C. 1997).

12 *FTC v. Cardinal Health, Inc.,* 12 F. Supp. 2d 34 (D.D.C. 1998).

13 Pepsi in fact failed to raise any genuine issue of fact on the presence of a material cost difference. For purposes of this discussion, however, a significant cost difference can be assumed.

14 DEPARTMENT OF JUSTICE & FEDERAL TRADE COMMISSION, MERGER GUIDELINES § 1 (1992).

15 114 F. Supp. 2d at 247-59. Pepsi also advanced a claim that Coca-Cola's agreements with the FSDs amounted to a per se unlawful horizontal group boycott. That claim was dismissed as well. *Id.* at 259-60.

detailed survey of 99 fountain customers conducted by Pepsi, FSD delivery came in 35th in importance out of 38 factors.

With regard to the evidence of a cost difference, the problem Pepsi ran into was that, if a cost difference in fact existed, it did not translate itself into any price difference. Fountain syrup suppliers never charged different prices based on the method of the delivery. Nor was there any evidence that Coca-Cola's margins were any higher on sales of FSD-delivered syrup, the supposedly monopolized product, than on syrup delivered by other means. Thus, in sharp contrast to cases like *Staples*, where office superstore prices were 13 percent higher when not faced with competition from other superstores,[16] or *Cardinal Health*, where prices to independent drugstores were significantly higher because they had no viable alternatives to drug wholesalers,[17] there was no basis for concluding that the cost differences Pepsi alleged had any material impact on reasonable interchangeability from the buyer's perspective. Absent any evidence of impact on prices to customers, the court concluded that evidence of cost differences provided no basis for defining a separate product market.[18]

Several other factors also contributed to the outcome. Customers used various methods of delivery in practice. The highest utilization of FSD delivery was by quick-service restaurant chains, but even there some 29 percent of total volume was delivered by bottlers. Although there was not a lot of switching from bottler to FSD delivery – at least in part because relative prices did not change – customers did in fact switch when bottlers offered even small discounts (in the range of 10¢ per gallon or 1.5 percent) to get the delivery business. Relying on this evidence, and the absence of any evidence of a customer declining to switch in response to a distribution price change, the court determined that cross-elasticity of demand was high.[19] Perhaps most importantly, at least on a gut level, the former CEO of Pepsi-Cola North America, Brenda Barnes, testified that "never ever would I think of or refer to a delivery method as a market." This devastating admission was featured prominently in the court's opinion.[20]

Market power. With regard to Pepsi's proof of market power, the court addressed the question indirectly in the context of the discussion of product market definition. The court remarked that "PepsiCo has not submitted any evidence to show that Coca-Cola's prices are supracompetitive. As a matter of fact, there is no pricing evidence in the record before me at all."[21] The court also pointed out that "as a result of renewed competition in fountain syrup in recent years, Coca-Cola's prices dropped."[22]

Pepsi has repeatedly acknowledged that the soft drink industry is intensely competitive, and that the fountain channel is the most competitive channel in the industry. That widely acknowledged reality is sharply inconsistent with Pepsi's litigation position that the largest and most powerful buyers in this highly competitive business are not beneficiaries of this intense competition but are instead the victims of monopoly pricing.

In fact, the evidence that Coca-Cola had no power over price was startlingly strong. Pepsi's official strategic plan, approved by its board of directors the month after the lawsuit was filed, was to "take the margin out of fountain" for Coca-Cola by discounting aggressively at every major account. Pepsi actually exceeded its strategic plan goals, and cut

16 970 F. Supp. at 1074-78.
17 12 F. Supp. 2d at 42, 46-49.
18 114 F. Supp. 2d at 257-58.
19 *Id.* at 257-58.
20 *Id.* at 253.
21 *Id.* at 258.
22 *Id.*

Coke's fountain profits by over half. Pepsi described the pricing at one of the major accounts, Burger King, as "extraordinary," a "new benchmark for the industry." And Pepsi engineered the same result at virtually every major account, including McDonald's, Wendy's, Hardees, Sonic, and others. Of the 10 largest accounts, four were Pepsi's (Taco Bell, Subway, Pizza Hut, KFC), one (Arby's) was split, and the "margin was taken out" at each of the rest. The CEO of Pepsi North America testified proudly that Pepsi competed for every customer, leaving "no profit haven for Coca-Cola." Not much market power there.

Appeal. Pepsi has appealed the district court's decision to the Second Circuit. The case was heard on October 11, 2001, and, as this is written, is awaiting decision.

United States v. Visa USA

Background. The *Visa* case involved two matching expulsion rules imposed by Visa and MasterCard upon their card-issuing bank members. Both Visa and MasterCard are associations with bank members that issue cards to consumers bearing the respective acceptance brand marked on the card. The issuing banks obtain the customer relationship, choose the features to be offered with the card, select the credit and payment terms and requirements, and bear the credit risk. For years, banks have been able to issue cards on the Visa network, the MasterCard network, or both. Visa By-law 2.10(e) allows any issuer of Visa payment cards to issue cards on the MasterCard network, but it requires the expulsion of any member bank that issues cards on the American Express or Discover networks. MasterCard's Competitive Programs Policy (or "CPP") similarly allows MasterCard issuers to issue Visa cards, but requires expulsion of members issuing any American Express or Discover cards.[23] Pursuant to these provisions, bank issuance of American Express or Discover cards will also result in loss of membership in the only worldwide ATM networks – Plus, owned by Visa, and Cirrus, owned by MasterCard. Because virtually every bank in the United States is a member of Visa, MasterCard, Cirrus, and/or Plus, the effect of 2.10(e) and the CPP has been to preclude every bank in the country from issuing American Express cards or Discover cards. Accordingly, while the Visa and MasterCard networks are each supported by the volume of thousands of bank issuers, the American Express and Discover networks are supported by only one issuer apiece. These provisions exist only in the United States. Because of opposition from the European Union and other competition authorities abroad, 2.10(e) and the CPP have been abandoned (or prevented) everywhere else in the world.

The Department of Justice challenged the exclusionary rules under section 1 of the Sherman Act. The complaint alleged that By-law 2.10(e) was a horizontal combination of the bank members of Visa that restrained trade unreasonably in the market for issuing credit and charge cards to consumers, and in the market pursuant to which banks obtain card network services from the networks. The CPP was challenged, on the same bases, as a combination of the bank members of MasterCard.[24] After a lengthy trial, the district court concluded that 2.10(e) and the CPP were "clearly show[n]" to have a significant adverse impact on competition and consumer welfare in both markets and, therefore, "should be abolished."[25]

23 By-law 2.10(e) and the CPP are inapplicable to Diner's Club and Carte Blanche – both owned by Citibank, one of the largest Visa and MasterCard issuers.

24 The Department did not allege that 2.10(e) and the CPP were the product of a conspiracy *between* Visa and MasterCard. The Government did challenge, in a separate count, "dual governance," i.e., the fact that the same member banks owned and controlled both Visa and MasterCard. The district court ruled in favor of the defendants on this claim, finding that dual governance had effectively been abolished over the prior several years (after the Government investigation had begun) when banks committed themselves to one or the other association. In addition, the court found that the specific anticompetitive effects asserted by the Government had not been proven. *Visa,* slip op. at 77-82, 95-96.

25 *Id.* at 2, 5-7.

Market definition & market power. The *Visa* court found two product markets relevant for purposes of evaluating the exclusion rules. The first was the market for issuing general purpose credit and charge cards, i.e., cards that allow the holder to purchase goods and services with payment deferred – excluding cash, checks, money orders, cards used at a single merchant, and debit and ATM cards (for which payment is made immediately, not on a deferred basis). Notwithstanding the curious holding 15 years ago in *National Bancorp. v. Visa USA*[26] that credit and charge cards compete in the same market as other means of payment, the *Visa* court's findings on market definition were solidly grounded on the facts and sound economic principles. Among other things, the court found that a hypothetical monopolist of credit and charge cards could profitably raise the effective "price" of credit cards to consumers by a substantial amount. Using a critical loss analysis,[27] the court determined that, because issuers' price-cost margins were 26 percent, "a 5 percent increase in general purpose card prices would have to reduce general purpose card output by over 16 percent to make such a price increase unprofitable."[28] A sales loss of that magnitude was almost inconceivable.

The evidence also established that the discount rates charged to merchants for general purpose card acceptance were not responsive to the pricing of other payment devices. Merchants testified that they had no choice but to accept Visa and MasterCard even in the face of significant price increases. Nor, in setting the key component of merchant discount rates (called "interchange"), do Visa and MasterCard consider other payment choices. They look primarily to each other and secondarily to American Express and Discover.[29]

With respect to the second market, card network services – which, the court noted, was of particular importance in evaluating the competitive effects of the exclusion rules – the evidence of a distinct antitrust product market was unusually clear. In that market, the district court found, "the networks provide core network services that cannot reasonably be replaced by other sources."[30] For these services, i.e., "the infrastructure and mechanisms through which general purpose card transactions are conducted, including the authorization, settlement, and clearance of transactions,"[31] there were no substitutes at all. If a bank wanted to be in the card business, network services were indispensable. Accordingly, the only issue was whether, as defendants claimed, demand for credit and charge cards was so elastic that the derived demand for network services would be insufficient to allow the exercise of market power by a hypothetical monopolist. Since the court had already found that a hypothetical monopolist of credit and charge cards would possess substantial market power, and thus that demand was *in*elastic, the defendants' derived demand argument plainly could not be sustained. Instead, finding that a 10 percent increase in network services costs would increase issuers' total credit and charge card costs by only 0.2 percent, the court concluded that "there would be no loss to network transaction volume in the face of even a 10% increase in price for network services," and that it was "implausible that [banks] would exit the profitable credit and charge card market in response to a [0.2 percent] increase in price."[32]

Judge Jones also concluded that both Visa and MasterCard had market power, collectively and individually, in the network services market.[33] In addressing this question, the court relied on several facts. First, Visa and MasterCard had been able to increase

26 779 F.2d 592 (11th Cir. 1986); *see also SouthTrust Corp. v. Plus Sys., Inc.,* 913 F. Supp. 1517 (N.D. Ala. 1995).
27 *See generally FTC v. Tenet Health Care,* 186 F.3d 1045 (8th Cir. 1999).
28 *Visa*, slip. op. at 17.
29 *Id.* at 20-21. *See FTC v. Swedish Match,* 2000-2 Trade Cas. (CCH) ¶ 73,122 (D.D.C. 2000).
30 Slip op. at 22.
31 *Id.*
32 *Id.*
33 Because Visa and MasterCard are not issuers of cards, the question in the first market, the issuance of credit and charge cards, was whether competition had been impaired by the exercise of the card associations' power in network services.

interchange, the key component of the discount rates charged to merchants, very substantially without losing even a single merchant. Second, both defendants were able to price discriminate, charging different merchant discount rates based on perceived merchant needs. Third, defendants' combined market share was high at 73 percent of dollar volume (47 percent Visa, 26 percent MasterCard), and protected by significant barriers to entry.[34] Fourth, the effect of defendants' exclusion rules had been dramatic. As a result of the rules, defendants had in fact increased the price and restricted the output of network services significantly.[35]

Competitive harm. The district court had little difficulty in concluding that the exclusion rules harmed competition and consumers. In the credit and charge card market, the rules were a horizontal arrangement among competing bank issuers not to compete against each other by offering the different features and attributes of the American Express or Discover brands. Any agreement among competitors holding 73 percent of a market with high entry barriers to restrict brand competition among themselves will almost certainly result in some reduction in output and consumer choice.[36] That was particularly true in *Visa*, where the excluded networks would have been able to combine the unique aspects of bank issuance (especially access to customers' bank accounts) with the unique aspects of the American Express and Discover networks (more detailed consumer information, smart card capability, superior corporate and small business card infrastructure for American Express, cash-back discount and low merchant discount rates for Discover) to create new products otherwise unavailable to consumers. By excluding the American Express and Discover networks from access to banks, moreover, Visa and MasterCard were able to keep the entire debit card market to themselves – blocking American Express and Discover entirely.

Harm in the network services market was, if anything, more obvious. Banks represented essentially all the customers of network services, but were limited to just two choices, Visa and MasterCard. Because American Express and Discover would have competed for the business of banks by offering better financial terms and different, potentially superior, network services, the effect of the exclusion rules in reducing price competition, restricting output, impairing innovation, and reducing quality and consumer choice was apparent to the court.[37]

Exclusive dealing issues. Exclusive dealing issues arose in *Visa* largely as a matter of attempted defense. Specifically, the defendants, relying on the district court decision in *Microsoft*,[38] maintained that the ability of American Express and Discover to reach all consumers through the mail precluded any kind of finding of consumer harm. The district court rejected the argument on three main grounds. First, and most importantly, the argument ignored competition in the network services market. The customers in that market were the banks and the exclusion rules blocked American Express and Discover from access to any of them.[39] Second, in the card issuance market, banks were far more than mere distributors. Banks established the features and product configurations on the cards issued

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34 *Id.* at 25-30.

35 *Id.* at 102-03.

36 In cases involving horizontal agreements, the key question is whether the competitors have reduced their *own* output – as the banks clearly had done in *Visa* by agreeing to limit the number of brands they would use – and an inquiry into market output is generally unnecessary. *See* A.D. Melamed, *Exclusionary Vertical Agreements* (Apr. 2, 1998), *available at* www.usdoj.gov/atr/public/speeches/1623.htm. In *Visa*, however, it was also clear – and the court found – that output had been reduced market-wide.

37 *Id.* at 111-34. The effect in the network services market was an important factor distinguishing *SCFC ILC, Inc. v. Visa USA,* 36 F.3d 958, 968 (10th Cir. 1994), on which Visa heavily relied. That case, involved Visa By-law 2.06, which prevented a bank owned by Discover from joining Visa and issuing Visa cards. The court ruled against Discover for the basic reason that the preclusion of one bank from issuing Visa cards had no substantial adverse effect on credit card issuance since thousands of other issuers remained. For purposes of that analysis, the focus necessarily was at the issuer level, not the network level. The addition of Discover to the Visa network would also have allowed Discover to free ride on Visa's network – a consideration absent in the current *Visa* case where American Express and Discover were seeking to have banks ride on *their* networks.

38 *United States v. Microsoft Corp.,* 87 F. Supp. 2d 30, 53 (D.D.C. 2000), *aff'd in part, rev'd in part,* 253 F.3d 34 (D.C. Cir. 2001). See text accompanying note 43 below.

39 Slip op. at 103-04.

and were more properly viewed as manufacturers rather than distributors. Banks also provided access to consumer bank accounts that were not merely desirable but indispensable in allowing the American Express and Discover networks entry into the market for debit cards and for the future development of multi-function cards with combined debit, credit, smart card, and other functionality dependent on consumer bank account access.[40] Third, even as "distributors," banks provided capabilities that American Express and Discover could not achieve through other means, including effective cross-selling opportunities with bank customers, many thousands of branches as points of sale, and the additional scale and merchant acceptance likely to result from the added volume. Visa and MasterCard had the benefit of thousands of issuers apiece and acknowledged that they would be much less effective competitors if limited, as were American Express and Discover, to just one.[41]

Appeal. Defendants have announced their intentions to appeal the district court's decision to the Second Circuit. A decision will come no earlier than some time in 2002.

Microsoft

Background. The facts of the *Microsoft* case are well known, and the discussion here will be limited to the exclusive dealing aspects of the proceedings. Microsoft had entered into arrangements with various computer manufacturers (OEMs), Internet access providers, Internet content providers, independent software vendors, and Apple Computer providing for some measure of exclusivity for its Internet Explorer browser versus Netscape's Navigator. Most of the agreements were entered into at times when Navigator's lead over IE in browser usage was substantial. Microsoft was able to achieve its exclusive arrangements through the power of its Windows operating system – insisting, for example, that OEMs not display Navigator on their computers' initial start-up screens, or that the Internet access providers distribute IE rather than Netscape Navigator as a condition for inclusion in the Windows "online services" folder.

It was clear that Microsoft had significant monopoly power in the market for personal computer operating systems. Although contested by Microsoft, both the district court and the court of appeals had little difficulty in concluding that PC operating systems comprised a relevant product market and that Microsoft had very substantial monopoly power in that market.[42]

Exclusive dealing issues. The Government challenged the exclusive and partially-exclusive arrangements in three "exclusive dealing" contexts: (1) as unlawful exclusive dealing under section 1 of the Sherman Act; (2) as supporting an attempt to monopolize the market for Internet browsers; and (3) as contributing to the maintenance of monopoly power in the operating systems market by the suppression of Netscape's Navigator as "middleware" – a platform for the launching of software applications independent of the underlying operating system. The district court ruled for Microsoft on the section 1 claim, but ruled in the Government's favor on both the attempted monopolization and monopoly maintenance claims under section 2.

The district court rejected the section 1 claim because Microsoft had not "completely excluded Netscape" from reaching any potential user in that Netscape could be

40 *Id.* at 120-24.

41 *Id.* at 114-20, 124-26. At various points in the course of the Government's investigation, and during the litigation, Visa and MasterCard sought to defend using "essential facilities" standards as well as exclusive dealing standards. But the Government never asserted that banks were "essential facilities" and the occasionally serious free rider and similar justifications that have led the courts to impose rigorous standards for "essential facilities" claims were in no way applicable on the *Visa* facts. *See generally Twin Laboratories v. Weider Health & Fitness,* 900 F.2d 566 (2d Cir. 1990) (plaintiff sought to advertise in defendant's magazines).

42 253 F.3d at 50-58.

(and regularly was) downloaded free on the Internet or made available widely through independent distribution of free CD-ROMs. Because the evidence thus failed to demonstrate "that Microsoft's arrangements excluded Netscape altogether from access to [at least] forty percent of the browser market," the district court determined that section 1 had not been violated.[43] With regard to the section 2 claims, however, the district court found that the arrangements had excluded Netscape from the most efficient means of distribution without sufficient justification and therefore contributed unlawfully to an attempt to monopolize the browser market and the unlawful maintenance of the monopoly of PC operating systems.

The court of appeals affirmed in part and reversed in part. The ruling on the section 1 claim had not been appealed by the Government and, so, was left intact at the appellate level – but the court of appeals clearly signaled its disagreement. The court said that a monopolist's use of exclusive contracts may violate section 2 "even though the contracts may foreclose less than the roughly 40% or 50% share usually required" under section 1, but it otherwise ruled that the standards under sections 1 and 2 for evaluating exclusionary conduct are generally the same.[44] The court held that Microsoft's arrangements had violated section 2 by denying Netscape the most cost-effective means of distribution without sufficient competitive justification, and flatly rejected any "total exclusion" test. The court ruled that each category of exclusive dealing arrangement, considered individually, violated section 2 as an exclusionary act designed to block the middleware threat represented by Netscape, thus maintaining Microsoft's monopoly of the market for PC operating systems.[45]

The court of appeals reversed the attempted monopolization ruling. Despite the determination that Microsoft's arrangements had denied Netscape access to the most cost-effective means of distribution of its browser, the Government had failed to establish that browsers comprised a valid relevant product market or that barriers to entry protect a putative monopolist's power within such a market. Because a "court's evaluation of an attempted monopolization claim must include a definition of the relevant market" and a showing of barriers to entry, the attempt claim was deficient as a matter of law. Proof of exclusionary conduct, without proof of power, was not enough.[46]

Dentsply

The decision in the *Dentsply* case denied a summary judgment motion by the defendant seeking dismissal of the Government's claims under sections 1 and 2 of the Sherman Act and section 3 of the Clayton Act. Dentsply is the nation's largest manufacturer of artificial teeth, with a market share that has ranged from 70 to 80 percent over the last 10 years. The Government challenged Dentsply's exclusive dealing policy with 30 independent dealers, through which all of Dentsply's teeth were sold.

Dentsply did not dispute, for purposes of its motion, that the sale of artificial teeth in the United States was an appropriate relevant market or that Dentsply had monopoly power in that market. Its motion for summary judgment was based primarily on two arguments: (1) that any foreclosure was insubstantial because competitors could sell directly to other laboratories, use non-Dentsply dealers, or induce dealers not stocking artificial teeth to begin doing so; and (2) that Dentsply's exclusive arrangements were terminable at will

43 87 F. Supp. 2d at 53.
44 *Compare* 253 F.3d at 70 *with id.* at 58-59.
45 *Id.* at 59-74. The court said: "[A]lthough Microsoft did not bar its [browser] rivals from all means of distribution, it did bar them from the cost-efficient ones." *Id.* at 64.
46 *Id.* 80-81, 95 (citing *Spectrum Sports v. McQuillan,* 506 U.S. 447, 459 (1993)).

without cause at any time, allowing competing teeth suppliers to compete for the distribution business of Dentsply's distributors at all times.

The district court rejected both arguments and denied the motion. With regard to the argument that other dealers and distribution channels were available, the court concluded that issues of fact precluded a determination that these alternatives were necessarily viable.[47] The Government pointed to evidence that direct sales were considerably more costly than selling through established dental dealers and that the non-Dentsply dealers cited by the defense in fact had little experience or effectiveness in distributing artificial teeth to dental laboratories, the purchasers of artificial teeth.[48] With regard to the argument that the dealer agreements were terminable at will at any time, the district court again found that issues of fact precluded summary judgment but, apart from distinguishing generally the cases where the short-term nature of exclusive agreements led to rulings in defendants' favor,[49] the court did not really explain why the short-term aspect of Dentsply's arrangements did not warrant judgment as a matter of law.[50] The argument advanced in the Government's brief, on which the district court presumably relied, was that, "as a practical matter, [the agreements were] self-perpetuating" because no dealer would abandon the powerful Dentsply line altogether to carry one of the smaller brands.[51] The Government, relying on the recent district court decision in *Minnesota Mining & Manufacturing Co. v. Appleton Papers, Inc.*,[52] argued that the short-term nature of the agreements was a factor to be considered, but not controlling, absent proof that dealers would likely switch to competing suppliers sufficiently to facilitate meaningful entry into the relevant market. Perhaps most importantly, the Government also presented evidence that the effect of exclusive distribution had been to allow Dentsply to raise market prices, restrict output, and reduce market quality by precluding the effective distribution of superior artificial teeth products.[53]

II. MESSAGES FROM THE RECENT DECISIONS

On the most basic level, the results in *Pepsi, Visa, Microsoft,* and *Dentsply* were different. The plaintiff prevailed in *Visa* and *Dentsply*, won some and lost some in *Microsoft*, and lost in *Pepsi*. But in fundamental respects, the decisions were entirely consistent.

First, in each instance in which the relevant market was established and the defendant's market power shown, the defendant lost. Where the market was not proven and market power was not shown, the defendant won. This was no fluke. Proof that real market power was subject to expansion or protection by the exclusive arrangements in issue was central to the theory of competitive harm advanced in each case. There was fundamental agreement that exclusive dealing – particularly with distributors or other intermediaries – poses no threat to consumers unless it raises the costs of (or otherwise impairs) rivals to a substantial extent *and*, in so doing, permits the defendant to raise prices above or restrict output below the competitive level.[54]

Second, the cases were consistent in emphasizing the unsurprising proposition that, in evaluating exclusive agreements with distributors, the potential for competitive harm varies with the significance of the distributor in reaching the ultimate purchaser. In *Pepsi*,

47 2001-1 Trade. Cas. at 90,140-41. Dentsply also argued that its business justifications warranted summary judgment. The district court had little difficulty rejecting that argument. *Id.* at 90,141.
48 Government's Memorandum in Opposition to Motion for Summary Judgment at 26-35, *United States v. Dentsply, Inc.,* No. 99-005 (D. Del., filed May 3, 2000), *available at* www.usdoj.gov/atr/cases/-f7000/7048.pdf.
49 *See* the cases cited *supra* note 8.
50 2001-1 Trade Cas. at 90,139-41.
51 Government's Memorandum in Opposition to Motion for Summary Judgment at 24-25.
52 35 F. Supp. 2d 1138 (D. Minn. 1999).
53 Government's Memorandum in Opposition to Motion for Summary Judgment at 16-17.
54 *See* Parts III and IV below.

despite hard-pressed allegations that access to foodservice distributors was critical in reaching restaurant customers, the evidence established that Pepsi competed effectively – and was certainly able to constrain Coca-Cola's pricing – using bottler delivery. In *Visa*, in contrast, the only route to debit or other bank account-based card functionality was through banks, banks designed and established the features of the products that were sold, and banks provided customer relationships that could not be utilized as effectively through other means. Similarly, in both *Dentsply* and *Microsoft*, the foreclosed distribution channels were found significant to effective competition.

Third, the short-term nature of the exclusive arrangements was not regarded as dispositive in any of the cases. Both *Dentsply*, under sections 1 and 2 of the Sherman Act and section 3 of the Clayton Act, and the motion to dismiss decision in *Pepsi*, under section 2, considered the issue squarely. In *Microsoft* and *Visa*, the issue was not addressed, but in fact many of the agreements in those cases were not of long duration and yet no one considered that fact to be especially critical to the competitive analysis. In both cases, the duration of the agreements had little to do with the real-world lack of any credible ability to switch to alternative suppliers.

Finally, but perhaps most significantly, in each case where liability was found, there was substantial proof of consumer harm. In *Pepsi*, the failure to prove market power, coupled with the undisputed evidence of competitive pricing, demonstrated the absence of consumer injury. In *Dentsply*, at least for summary judgment purposes, the Government prevailed based on its direct evidence of increased prices and diminished quality. In *Visa*, the exclusion rules led directly to higher prices and reduced output in the market for card network services, and to reduced output, innovation, and brand competition in the credit and charge card issuance market. In *Microsoft*, the proof of consumer harm was considerably more subtle, but nevertheless substantial. The possession of monopoly power in computer operating systems harms consumers immediately through increased prices – consider, for example, Microsoft's 2001 pricing initiatives with corporate customers and the new "activation" feature for Windows XP[55] – and over the longer run through diminished innovation. Microsoft's liability was based on findings that the exclusionary arrangements contributed to the maintenance of that monopoly power.

In three of these recent cases, *Pepsi*, *Visa*, and *Microsoft*, as well as in *FTC v. H.J. Heinz Co.*,[56] a recent and highly significant merger case, the proof (or lack of proof) of harm to consumers was hotly disputed in ways calling into question the very nature of "consumer harm" in the antitrust sense. The debate, which is particularly important to an understanding of the law of exclusive dealing – and of antitrust analysis generally – is discussed in Part III immediately below.

III. THE NATURE OF CONSUMER HARM

We talk about "consumer harm" in virtually every case as if everyone knows what it means. There is general agreement that consumer harm includes reductions in allocative efficiency – the "deadweight" or welfare loss reflected in standard microeconomic models, generally derived from a restriction in output, and usually associated with an increase in price or reduction in quality.[57] Some observers include also the "wealth transfer" effect that

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55 *See generally* R. Buckman, *Microsoft Software Pricing Plan Draws Fire From Corporate Users*, Wall. St. Journal (Sept. 25, 2001).
56 246 F.3d 708 (D.C. Cir. 2001).
57 *See* F.M. SCHERER & D. ROSS, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE 21-29 (3d ed. 1990); 2A P. AREEDA & H. HOVENKAMP, ANTITRUST LAW ¶ 502 (rev. ed. 1995); R. BORK, THE ANTITRUST PARADOX, chs. 4, 5 (1978).

arises when, for example, prices are increased to consumers (and wealth is accordingly transferred to producers) without a reduction in output, as when a monopolist is able to engage in perfect price discrimination.[58] Without re-engaging that debate, the focus here is only on allocative efficiency.[59]

Limiting the focus to allocative efficiency does not, however, provide all the answers. Pepsi has argued, for example, that proof of an increase in rivals' costs suffices to show consumer harm. Other parties in recent cases have raised arguments that a demonstration by the Government (or a private plaintiff) of consumer harm in the form of increased prices or reduced output is not enough. They say that proof of harm even to consumers directly in the form of higher prices or reduced output is insufficient unless quantified; that proof of higher prices to a retailer or other intermediary in the distribution chain is not cognizable absent proof that the price increase has been or necessarily will be passed on to consumers; and that proof of reduction in consumer choice alone does not qualify as consumer harm even if the result is one choice rather than two (or two rather than three). The discussion below considers these propositions in turn.

Increasing rivals' costs

Among the principal contentions in the *Pepsi* case is that, at least in a market with two significant competitors, an increase in the primary rival's costs – without more – is sufficient proof of consumer harm.[60] If there were *absolutely nothing else* going on, an increase in marginal costs for the market as a whole would indeed represent an allocative efficiency loss and create grounds for concern. But apart from a case of bombing the plant of the competitor's distributor or the like, there is virtually no plausible scenario in which the *only* impact of an exclusive dealing arrangement is an increase in rivals' costs.[61]

There are invariably *some* efficiencies associated with any exclusive dealing arrangement. Exclusive distribution provides incentives to the distributor to maximize sales of the supplier's brand. Even if the distributor performs no sales function, exclusivity provides a similar incentive to perform the basic delivery function more effectively. Having exclusive distributors, moreover, necessarily reduces the supplier's costs in monitoring the performance of the distributors to make sure they are not improperly favoring the rival's brand.[62] The *strength* of any of these efficiencies may be questioned in any given case, but not their existence.

The nature of the increase in the rival's costs also needs to be examined carefully, for in many cases it may be a simple byproduct of competition. If the defendant, for example, procures exclusives with all the most effective distributors while his rivals remain idle, rivals' costs may increase but not in any way that poses a threat to the competitive process.[63] The effect of exclusivity in this instance may be to encourage the rival to develop new methods of distribution, or to come up with programs designed to make the weaker distributors (not committed to the defendant) more effective, or to outbid the defendant for the contracts with the distributors the defendant is using.[64] A rule that would allow an

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58 *Compare* R. Lande, *Wealth Transfers as the Original and Primary Concern of Antitrust: the Efficiency Interpretation* challenged, 34 HASTINGS L.J. 65 (1982) *with* R. BORK, THE ANTITRUST PARADOX, *supra* note 57, chs. 2-6.

59 One aspect of allocative efficiency that is considered here, and is often highly relevant in evaluating the impact of exclusionary conduct, is the social loss that arises when the resources of excluded rivals or customers are diverted from their most efficient uses. *See* H. Hovenkamp, *Antitrust's Protected Classes*, 88 MICH. L. REV. 1, 17-20 (1989).

60 *See* PepsiCo's Reply Brief at 2-9, *PepsiCo, Inc. v. Coca-Cola Co.,* No. 00-9342 (2d Cir., argued Oct. 11, 2001).

61 The *Visa* case presents such a scenario, but it is not an exclusive dealing case. The Visa/MasterCard rules excluded smaller rivals – but not themselves. The efficiencies associated with exclusive dealing, therefore, were absent.

62 *See generally* H. Marvel, *Exclusive Dealing*, 25 J.L. & ECON. 1 (1982).

63 *See Gilbarco*, 127 F.3d at 1163.

64 *See Paddock Publications v. Chicago Tribune,* 103 F.3d 42 (7th Cir. 1996).

inference of consumer harm without considering these potential effects as well has not received any support in the cases.

The character of the costs in issue must also be considered. Distribution is typically one of many inputs into a final product and may represent a relatively small portion of total cost. Even if distribution represents as much as 10 percent of total product costs and the exclusive arrangement raises distribution costs by 10 percent, the impact on total product costs is only one percent. Competitive effects of that low magnitude are not usually the product of serious antitrust concern. The point is underscored by the reality that firms' production costs differ, often dramatically, in every case. Plaintiff *P* may well be able to offset defendant *D*'s distribution cost advantage by reducing its ingredient costs, its labor costs, or through other means. Courts have not inferred any enhanced ability to raise price from an adverse impact on rivals' costs, without more.

An increase in rivals' costs may prove to be important in analyzing the competitive impact of a practice. But, standing alone, an increase in competitors' costs is not evidence of consumer harm.

Quantifying consumer harm

It is well accepted that consumer harm is shown through a reduction in output. Typically, reduced output is associated with an increase in price. But the concept is not limited to cases where fewer units are produced or price is raised. Reduced output may also be reflected in a reduction of quality, loss of innovation, or a significant reduction in consumer choice. In a monopsony or buyer monopoly case, reduced output is normally associated with a price decrease.[65]

If the antitrust plaintiff proves a material reduction in market output, should more be required? According to arguments put forth by Visa, and to some extent by Microsoft, the answer is "yes." Citing the Supreme Court's decision in *California Dental Association v. FTC*,[66] the argument advanced is that, absent some specific quantitative or qualitative estimates of the amount of the reduction in output or increase in price, consumer harm has not been shown.[67] The Government's case in *Visa* was insufficient, according to this argument, because the Government's expert did not quantify the incremental number of credit cards that would have been brought to market had the restrictions been removed.[68] This kind of evidence was required, according to the argument, based on *California Dental*'s insistence on empirical evidence, rather than assumptions, when "the circumstances of the restriction are somewhat complex . . . . "[69]

California Dental considered a dental association's rules inhibiting price advertising. The Supreme Court majority concluded that the impact of the rules on competition was ambiguous in light of the serious information imperfections in the dental care market. One possibility, advanced by the defense, was that the restrictions promoted allocative efficiency by discouraging misleading advertising. Another, advanced by the FTC, was that the rules reduced welfare by making it more difficult for consumers to find low-cost providers. Given what the majority deemed to be plausible arguments on both sides as to whether the restrictions would increase or decrease market output, the Court's insistence on empirical

65 R. BORK, *supra* note 57, at 90-110; J. Jacobson & G. Dorman, *Joint Purchasing, Monopsony* & *Antitrust,* 36 ANTITRUST BULL. 1, 5-18 (1991).
66 526 U.S. 756 (1999).
67 D. Evans, *Dodging the Consumer Harm Inquiry: A Brief Survey of Recent Government Antitrust Cases*, 75 ST. JOHN'S L. REV. 3 (2001) (forthcoming).
68 *Id. See* Defendants' Joint Proposed Findings of Fact & Conclusions of Law, part VII, at 54-58, *United States v. Visa USA,* No. 98-7076 (BSJ) (S.D.N.Y., filed Sept. 22, 2000). The equivalent argument in *Microsoft* was that consumer harm in browsers had not been shown because there was no evidence as to the quantity of additional users of Netscape Navigator. *See* Brief for Microsoft Corp. at 118, *United States v. Microsoft Corp.,* 253 F.3d 34 (D.C. Cir. 2001)
69 526 U.S. at 775.

evidence of *some* probability of a decrease in output is understandable. That is not, however, a holding that the FTC had to estimate the amount by which output had been reduced.

Imposing on an antitrust plaintiff the burden of proving, in a rule of reason case, some output reduction or other allocative efficiency loss is a requirement recognized in the case law. Elevating that burden to include a quantification requirement, however, is supported by no precedent or policy consideration. In most cases, the presence of meaningful output reduction can be discerned from the evidence, but quantification would be difficult and would open up the expert providing the quantification to largely irrelevant pot-shots at his or her data or methodology. In *NCAA*,[70] for example, it was pretty reasonable to infer a reduction in the output of televised college football games from the fact that an association of all the major colleges, the NCAA, had limited the number of televised games by rule. It would seem superfluous to require evidence of the number of additional games that would be televised without the rule. Similarly, in *Visa*, there was evidence Visa and MasterCard competed against each other for bank issuer volume by offering financial inducements, but that they viewed these inducements as harmful and had developed strategies to avoid or reduce them. The evidence was also clear, and not seriously disputed in this respect, that these inducements would increase in amount and frequency – thus reducing the effective price charged for card network services – if American Express and Discover were not prevented from competing for banks. With the fact established that the exclusion rules caused some material increase in the price for card network services, would it have made sense to require further proof of the amount of the increase or the associated diminution in card network services output? The district court, at least, implicitly answered that question in the negative.[71]

Increased prices to intermediaries

In some recent cases, most prominently *Visa* and *FTC v. H.J. Heinz Co.*,[72] the argument has been advanced that increased pricing to a distribution chain intermediary is not itself consumer harm; there must also be evidence that some portion of the price increase will be passed along to consumers.

In *Visa*, the argument was that an increase in price of card network services provided to banks was not consumer harm absent evidence of an increase in the price or a decrease in the output of credit or charge cards. Visa and MasterCard pointed to the fact that American Express and Discover, as card issuers, were able to reach all consumers through the mail. They argued, therefore, that no adverse effect on price or output of cards could be shown and that, without an adverse effect on the end product, consumer harm could not be established.[73]

In *Heinz*, the argument was more subtle. The defense argued that, in evaluating the likely impact of the proposed Beech-Nut/Heinz baby food merger, a reduction in the level of suppliers' trade spending to retailers was not an anticompetitive effect absent proof that the sums varied on the basis of volume. Variable spending would be passed along to consumers in the form of discounts off the sales price, but "fixed" trade spending (or lump-sum payments) would be pocketed instead by the retailer. The fixed payments would reduce retailers' total costs, but to the extent competition forced the cost reduction to be passed along to consumers, it might be through price reductions on other products, with no

70 *NCAA v. Board of Regents,* 468 U.S. 85 (1984).
71 *Visa*, slip op. at 7, 97
72 246 F.3d 708 (D.C. Cir. 2001), *rev'g* 116 F. Supp. 2d 190 (D.D.C. 2000).
73 *See Visa*, slip op. at 103.

associated benefit to consumers of baby food. The district court, upholding the merger, accepted the argument.[74]

The arguments advanced in *Visa* and *Heinz* were ultimately rejected. In *Visa*, the court held that the adverse impact of the exclusion rules in the network services market sufficed to establish a violation of section 1, although the court also found specific harm at the consumer level.[75] In *Heinz*, the court of appeals held that consumer harm was established by evidence of a price increase to a retailer, even in the form of a reduction in lump-sum trade spending only, because "the antitrust laws assume that a retailer faced with an increase in the cost of one of its inventory items 'will try to pass that cost on to its customers in the form of a higher price for its product.'"[76]

A reduction in lump-sum payments for baby food to the grocery store does not affect the retailer's marginal cost, and unless voluntarily applied by the retailer to units of baby food will not reduce the baby food shelf price. But if the retail markets are competitive, as they tend to be, the lump-sum payments will be competed away in some other form, for example by providing wider aisles or double-couponing or other amenities to retailers' customers generally. The result is a benefit to consumers as a group, although much – perhaps the vast majority – of the benefit goes to consumers not purchasing baby food. The loss of this competition is nonetheless welfare-reducing and represents cognizable consumer harm.

From a legal perspective, it should also be recognized that an entire body of law turns on the premise that harm to intermediaries is harm that the antitrust laws will prevent. *Hanover Shoe*[77] held that a defendant cannot avoid damages liability by proving that a price increase was passed along to a customer, and *Illinois Brick*[78] confirmed and reinforced that principle by holding that only direct purchasers – who typically are intermediaries – have a right to recover damages. A holding that an antitrust violation cannot be demonstrated by proof of a price increase or other harm to an intermediary would be difficult to reconcile with those decisions.

Reductions in consumer choice as reductions in output

Yet another argument advanced by Visa and MasterCard in the *Visa* case was that, in terms of analyzing effects in the credit and charge card issuance market, it mattered not that consumers could not get bank-issued American Express and Discover cards; consumers had ample choices in bank-issued Visa or MasterCards and in cards issued by American Express and Discover on their own networks.[79] Given the abundance of record evidence in the case that, in fact, new and different products would result if banks were permitted to issue cards on the American Express or Discover networks, the district court rejected the argument as a factual matter.[80] But what if the argument were supported by evidence – would a reduction in network choices for banks from four to two, or a reduction in credit or charge card variety and choices to consumers by a similar ratio suffice to prove consumer harm?

74 116 F. Supp. 2d at 197. The origin of the dispute on the issue is unclear. It appears that the FTC staff indicated that they would prove that ultimate consumers would be harmed by a reduction in fixed trade spending – and that the defense was responding to this argument rather than arguing affirmatively that a reduction in fixed trade spending could not be viewed as cognizable consumer harm. The defendants' district court brief appears, however, to advance the affirmative argument. *See* Defendants' Post Trial Brief and Conclusions of Law at 17-18. The district court opinion is ambiguous on the point., 116 F. Supp. 2d at 197. The court of appeals read the district court's opinion as having held, as a legal matter, that proof of harm to retailers was insufficient absent evidence of impact at the consumer level. 246 F.2d at 718-19.

75 *Visa*, slip op. at 103-04

76 246 F.3d at 719 (quoting *In re Brand Name Prescription Drugs Antitrust Litig.,* 123 F.3d 599, 605 (7th Cir. 1997)).

77 *Hanover Shoe, Inc. v. United Shoe Mach. Corp.,* 392 U.S. 481 (1968).

78 *Illinois Brick Co. v. Illinois,* 431 U.S. 720 (1977).

79 Defendants' Joint Proposed Findings of Fact & Conclusions of Law, *supra* note 68, part VII, at 49-52.

80 *Visa*, slip op. at 126-33, 150-51.

Choice and variety comprise one dimension of output. A material reduction in the choices available is no different in kind than a reduction in quality, and all agree that a deterioration in quality is a cognizable form of consumer harm.[81] There must, however, be some limiting principle. Most horizontal mergers, for example, involve some likely reduction in choice as product lines are combined. A reduction in the choice of suppliers of a commodity product, such as salt, from 1000 to 999 does not make for much of an antitrust case. And unlike a case involving an objective reduction in quality, relative degrees of choice can become largely matters of subjective taste.

Choice is also more important in some contexts than in others. For garden variety commodity products, degrees of choice may be insignificant. For products differentiated by brand only, choice will matter but it will not necessarily matter much. For products differentiated by price, features, or quality, choice will matter more.

The difficult question is determining when a reduction in consumer choice rises to the level of material consumer harm. Any answer, unfortunately, will be arbitrary. One way of evaluating the issue is to look to principles of horizontal merger law. In a well-defined market, provided there is evidence of barriers to entry, mergers reducing the number of competitors from three to two are invariably condemned – even in cases involving substantial efficiencies.[82] Correspondingly, however, mergers reducing the number of competitors from ten to nine or, under current practice, from six to five, are rarely challenged.[83] Using horizontal merger principles as a rough proxy, a reduction in choices from three to two would be presumptively harmful (at least for reasonably differentiated products), the loss of one choice with five or more remaining would be presumptively lawful, and cases in the middle would remain presumption free.

IV. ANALYSIS OF CONSUMER HARM IN CASES INVOLVING EXCLUSIVE DEALING WITH DISTRIBUTORS

Analysis of consumer harm in any exclusive dealing case implicates the rule of reason.[84] Years ago, a common complaint was that the rule of reason was contentless, standardless, subjective, and too complicated and therefore too costly to apply.[85] That is no longer true. Cases and commentators have moved towards general agreement at least on the basic structure of rule of reason analysis. Of course, some differences remain[86] and certain questions are still unanswered.[87] But there is basic agreement that a plaintiff must present a prima facie case of harm to competition in a relevant market; that the burden of production (but not persuasion) then shifts to the defendant to present evidence of competitive justification; and that the plaintiff may rebut the proffered justifications to demonstrate that the net effect of the challenged arrangement is to impair competition.[88]

A review of *Pepsi*, *Visa*, *Microsoft*, *Dentsply*, and other recent cases indicates a substantial degree of consistency in the courts' analysis of exclusive dealing restraints. The ultimate question the courts have asked is whether the agreements in question harm consumers by creating, enhancing, or protecting significant market power. The methodology of reaching an answer has largely proceeded as follows:

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81 The classic case is *National Macaroni Mfrs. Ass'n v. FTC,* 345 F.2d 421 (7th Cir. 1965) (reduction in durum wheat content in macaroni).
82 *Heinz*, 246 F.3d at 717.
83 *See* cases cited in ABA ANTITRUST SECTION, 2000 ANN. REV. ANTITRUST L. DEV. 92-94 (2001).
84 *Tampa Electric Co. v. Nashville Coal Co.,* 365 U.S. 320 (1961).
85 *E.g., Northern Pac. Ry. v. United States,* 356 U.S. 1, 5 (1958).
86 *See* A.D. Melamed, *Exclusionary Vertical Agreements* (Apr. 2, 1998), *available at* www.usdoj.gov-/atr/public/speeches/1623.htm.
87 For example: If justifications are presented, are they controlling? Or can the plaintiff rebut not only their existence and scope, but their strength in relationship to the competitive harm in question?
88 *See generally Microsoft*, 253 F.3d at 58-59 (structured rule of reason under section 2); ABA ANTITRUST SECTION, MONOGRAPH 23, THE RULE OF REASON (1999).

Step 1: Plaintiff's prima facie case

a. Proof of defendant's market power

The core concern about exclusive dealing is that it will reduce allocative efficiency; that the restraint will empower the defendant, by impairing rivals, to raise the market price of the product in issue (or otherwise harm consumers by reducing output, quality, choice, or innovation). This inquiry cannot proceed in any meaningful fashion absent a determination of the particular price and output in issue, and it requires an assessment of whether an adverse impact on that price or output is likely or feasible. Accordingly, the first task in any vertical exclusive dealing case is to define the relevant market and then assess the defendant's power, if any, in the market. That step, the cases say, is essential to determine whether harm to the competitive process is possible. Whenever plaintiffs have tried to shortcut proof of power – such as in *Pepsi*, by alleging that the exclusionary arrangement represents a "naked" restraint obviating the need for independent proof of the relevant market or the defendant's market power – the courts have said "no."[89] As the *Microsoft* court held, when "an exclusive deal is challenged, it is true that in all cases the plaintiff must . . . define the market" and establish that the defendant has market power.[90] Absent proof of the power to cause consumer harm market-wide, an exclusive dealing restraint is at worst harmless, and may well be procompetitive.

b. Proof that restraint materially impairs rivals

The second element of the plaintiff's prima facie case is the degree of "foreclosure" the restraint has caused.[91] Although earlier cases referred to foreclosure only in the sense of the percentage of the relevant market covered by the exclusive restraint,[92] more recent authority requires a broader analysis of the extent to which rivals have been impaired, for it is the degree of impairment of rivals – not the mere percentage of business at issue – that determines the extent to which the exclusive arrangement may (on satisfying other conditions) allow the defendant to increase prices or otherwise cause consumer harm.[93] A significant impairment in this respect is one that materially reduces the rivals' ability to constrain the defendant's market power. If the restrictive arrangements leave competitors with a continued ability to constrain the defendant's market power, harm to competition has not been shown.

In a typical case involving exclusive dealing arrangements with distributors, demonstrating a material impairment of rivals' ability to constrain the defendant's power will require proof of at least the following: first, that rivals' costs have been increased through the denial of access to the distributors, or that some other major hurdle has been erected damaging the rival's ability to compete; second, that the cost increase (or other hurdle) cannot be avoided through reasonably practical means such as competing for the exclusive distributors, or by using or developing alternative means of distribution; and, third, that there are impediments to entry into the market by suppliers using different distribution methods or different distributors. The significance of the "foreclosed" distributors to effective competition, the duration of the defendant's contracts, any staggering of the termination dates, and distributors' practical ability to terminate the agreements will be additional key factors in this analysis.

89 *PepsiCo*, 114 F. Supp. 2d at 257-58. *See, e.g., Spectrum Sports, Inc. v. McQuillan*, 506 U.S. 447, 455-56 (1993).
90 253 F.3d at 69-70.
91 *See id.*
92 *E.g., Tampa Electric*, 365 U.S. at 328-29, 334-35.
93 T. Krattenmaker & S. Salop, *Anticompetitive Exclusion: Raising Rivals' Costs to Achieve Power Over Price*, 96 YALE L.J. 209 (1986).

c. Proof that the impairment in fact allows the defendant to harm consumers

The third part of the prima facie case, following from the first two, is proof that the exclusive dealing arrangements not only impair rivals but in fact allow the defendant to increase prices or otherwise cause consumer harm. This element will in some cases follow from the second, but that will not necessarily be the case.[94] Proof of an increase in rivals' costs is a necessary but not sufficient condition in establishing consumer harm. A likelihood of elevated prices or other harm to consumers must also be shown.

Care must also be taken to ensure that the plaintiff's alleged cost increase is not purely a byproduct of competition. If the plaintiff's costs are raised because the defendant outbid it in a fair fight for the best distributors, harm to competition has not been shown.

Step 2: Justification

If the plaintiff fails to establish a prima facie case, of course, the litigation ends. If a prima facie case is proven, however, the burden of producing evidence then is appropriately shifted to the defendant to present evidence in justification of the restraint.[95] The justifications presented are limited to those which may or will promote competition.[96] In an exclusive dealing context, they may include, among other reasons:

- increased dedication and effort for the supplier's brand,
- encouraging supplier investments by avoiding competitors' free riding,
- decreased out-of-stocks,
- preventing substitution (and passing off) of inferior products in place of the supplier's,
- reduced costs for the supplier in monitoring distributor behavior,
- reduced transaction costs, and
- quality certification through non-affiliation with inferior brands.

Step 3: Plaintiff's response

If the defendant fails to present any evidence of justification – a virtual impossibility in a vertical exclusive dealing case[97] – the plaintiff's prima facie case should prevail (absent a determination by the factfinder that the plaintiff's evidence should not be believed). If justification evidence is presented, the burden of going forward shifts back to the plaintiff as developed below. The ultimate burden of persuasion rests with the plaintiff at all times.[98]

a. Evidence of pretext

One time-honored method of rebutting a proffered justification is to present evidence that it is not true – either that the reasons underlying the claimed justification do not exist in fact or that, in the particular circumstances, they are merely being used as an excuse to cover up different and anticompetitive reasons. The Supreme Court in *Kodak* indicated that both of these types of rebuttal evidence may be used.[99]

94 In *Pepsi*, for example, whatever the quality of Pepsi's evidence of impairment, it was clear that Coca-Cola obtained no power over price. *See supra* text accompanying notes 21-22.
95 *See, e.g.*, *Eastman Kodak Co. v. Image Technical Servs.*, 504 U.S. 451, 483 (1992).
96 *National Soc'y of Prof. Engineers v. United States,* 345 U.S. 679, 695-98 (1978).
97 *Visa*, in contrast, was neither a vertical case nor an exclusive dealing case. With Visa prohibiting banks from dealing with American Express and Discover, but *not* MasterCard, and MasterCard adopting a reciprocal provision, the court found no evidence of justification at all. *Visa*, slip op. at 134-47.
98 *See In re Brand Name Prescription Drugs Antitrust Litig.,* 186 F.3d 781, 787 (7th Cir. 1999).
99 504 U.S. at 483.

b. Achievement of the same efficiencies through substantially less restrictive means

Justifications may also be rebutted through evidence of less restrictive alternatives. This does not mean that evidence of some hypothetical less (or "least") restrictive alternative will rebut a procompetitive justification.[100] However, a justification can in most circumstances be rebutted by evidence that the same efficiencies or other benefits could be achieved by other means that are both reasonably available and *substantially* less restrictive.[101]

If the plaintiff's evidence negates the evidence of justification, its prima facie case of consumer harm – no longer offset by any efficiency justification – will carry the day and the plaintiff will prevail.

Step 4: Balancing

Few cases will involve the need for much of a fourth step, and fewer still will call for "balancing" pro- and anti-competitive effects or objectives. Although cases may arise in which an exclusive arrangement has been shown to harm competition, subject to an efficiency justification that has not been substantially rebutted, the ultimate outcome will rarely depend on balancing. If a procompetitive justification is demonstrated, that will suggest, other things equal, that the arrangement is output-enhancing; but if the arrangement is likely to reduce output even giving consideration to the justifications advanced, the arrangement is anticompetitive. The determinative question in any case is the net effect on output or allocative efficiency and, if a net reduction in output has been shown, giving full consideration to the efficiency defense, there is no further balancing to be done. Only if the net effect on allocative efficiency is genuinely ambiguous will the factfinder truly need to "balance" the consumer harm against the strength of the defendants' justifications. The cases where that will be necessary should be exceedingly rare.

* * * * *

The analysis reflected in this paper will result in the approval, usually through summary disposition, of most exclusive dealing restraints. Exclusive dealing, particularly in distribution, is common in our economy today. Instances of true competitive harm are few and far between. Condemnation should be correspondingly difficult.

APPENDIX: KEY EXCLUSIVE DEALING CASES & OTHER AUTORITIES

SUPREME COURT DECISIONS

Tampa Electric Co. v. Nashville Coal Co., 365 U.S. 320 (1961)
Jefferson Parish Hospital District No. 2 v. Hyde, 466 U.S. 2, 45 (1984) (O'Connor, J., concurring)
Standard Oil Co. v. United States, 337 U.S. 293 (1949) (*Standard Stations*)
FTC v. Motion Picture Advertising Service Co., 344 U.S. 392 (1953)
Fashion Originators' Guild of America v. FTC, 312 U.S. 457 (1941)
United Shoe Machinery Corp. v. United States, 258 U.S. 451 (1922)
Standard Fashion Co. v. Magrane-Houston Co., 258 U.S. 346 (1922)

KEY CIRCUIT COURT DECISIONS

United States v. Microsoft Corp., 253 F.3d 34 (D.C. Cir. 2001) (en banc), *cert. denied*, 70 U.S.L.W. 3107 (U.S. 2001) (No. 01-236)
CDC Technologies v. IDEXX Industries, 186 F.3d 74 (2d Cir. 1999)
Western Parcel Express v. UPS, 190 F.3d 974 (9th Cir. 1999)
Omega Environmental v. Gilbarco, Inc.,127 F.3d 1157 (9th Cir. 1997)

100 *Continental T.V., Inc. v. GTE Sylvania Inc,* 433 U.S. 36, 49 (1977); *American Motor Inns v. Holiday Inns,* 521 F.2d 1230, 1249 (3d Cir. 1975).
101 *E.g., Bhan v. NME Hosps.,* 929 F.2d 1404, 1413 (9th Cir. 1991).

Paddock Publications v. Chicago Tribune Co., 103 F.3d 42 (7th Cir. 1996)
U.S. Healthcare, Inc. v. Healthsource, Inc., 986 F.2d 589 (1st Cir. 1993)
Ryko Mfg. Co. v. Eden Servs., 823 F.2d 1215 (8th Cir. 1987)
Rothery Storage & Van Co. v. Atlas Van Lines, 792 F.2d 210 (D.C. Cir. 1986)
United States v. Dairymen, Inc., 1985-1 Trade Cas. (CCH) ¶ 66,638 (6th Cir. 1985)
Roland Mach. Co. v. Dresser Indus., 749 F.2d 380 (7th Cir. 1984)
Barry Wright Corp. v. ITT Grinnell Corp., 724 F.2d 227 (1st Cir. 1983)
Twin City Sportservice, Inc. v. Charles O. Finley & Co., 676 F.2d 1291 (9th Cir. 1982)
American Motor Inns v. Holiday Inns, 521 F.2d 1230 (3d Cir. 1975)

KEY DISTRICT COURT DECISIONS

United States v. Visa USA, Inc., 2001-2 Trade Cas. (CCH) ¶ 73,440 (S.D.N.Y. Oct. 9, 2001)
United States v. Dentsply, Inc., 2001-1 Trade Cas. (CCH) ¶ 73,247 (D. Del. 2001)
PepsiCo, Inc. v. Coca-Cola Co., 114 F. Supp. 2d 243 (S.D.N.Y. 2000)
Bepco, Inc. v. Allied-Signal, Inc., 106 F. Supp. 2d 814 (M.D.N.C. 2000)
Minnesota Mining & Manufacturing Co. v. Appleton Papers, Inc., 35 F. Supp. 2d 1138 (D. Minn. 1999)
Sewell Plastics, Inc. v. Coca-Cola Co., 720 F. Supp. 1196 (W.D.N.C. 1989), *aff'd per curiam*, 912 F.2d 463 (4th Cir. 1990)
Kohler Co. v. Briggs & Stratton Corp., 1986-1 Trade Cas. (CCH) ¶ 67,047 (E.D. Wis. 1986)
United States v. Dairymen, Inc., 1983-2 Trade Cas. (CCH) ¶¶ 65,651 & 65,704 (W.D. Ky. 1983)
Joyce Beverages v. Royal Crown Cola Co., 555 F. Supp. 271 (S.D.N.Y. 1983)

SECONDARY SOURCES

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R. BORK, THE ANTITRUST PARADOX ch. 15 (1978)
R. Steuer, *Exclusive Dealing in Distribution*, 69 CORNELL L. REV. 101 (1983)
H. Marvel, *Exclusive Dealing*, 25 J.L. & ECON. 1 (1982)