Antitrust Implications of Category Management: Resolving the Horizontal/Vertical Characterization Debate

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Category management is evil. *It enables a dominant supplier to eliminate all of its rivals across an entire category of products and impose its will on weak and helpless retailers. It puts all competing suppliers at a huge competitive disadvantage by letting the "knighted" supplier roam freely over all of their sensitive business data and make decisions about which products will be on the shelves, in what quantities and at what prices. It also enables retailers to coordinate pricing with each other through a common supplier serving the role of category manager for multiple retailers at the same time. It destroys competition and should be banned from U.S. commerce.*

Category management is wonderful. *It enables the retailer to take a holistic approach to an entire category of products rather than determining profits and margins on an item-by-item basis. It makes great business sense for the retailer to get expert advice from a leading supplier about the overall category. The retailer does not have the financial or personnel resources to develop expertise in dozens, if not hundreds, of separate categories. Huge efficiencies flow from that transfer of knowledge—efficiencies that redound greatly to the retailer's, and ultimately the consumer's, benefit. Category management should be applauded, not condemned, and recognized as one of the greatest business innovations since the invention of the steam engine.*

Category management has led to strong reactions, pro and con. The concept of category management covers a broad range of commercial relationships and practices, and asking whether it is good or bad is therefore like asking the blind men in the parable whether the elephant is a tree or a snake: it depends on which part of the elephant they are touching. The debate over whether category management is on balance anticompetitive or procompetitive will no doubt rage for many years to come.

There is, however, one aspect of the current antitrust debate about category management that can and should be resolved, and soon. A few prominent antitrust commentators—who might usefully be called "horizontalists"—have recently suggested that, in the context of category management, discussions between a supplier and a retailer regarding the products of other suppliers should be treated as "horizontal" for purposes of determining antitrust liability. The distinction is of course critical because vertical practices (other than minimum resale price maintenance and tying) are subject to analysis under the rule of reason. Horizontal restraints, in contrast, are more readily condemned as unlawful per se. As this article will demonstrate, the characterization of category management relationships as horizontal does not withstand scrutiny. It is at odds with clear Supreme Court precedent and the weight of modern antitrust thinking on vertical distribution practices. By precluding rule-of-reason treatment for practices that may, in many cases, yield benefits for consumers, the horizontalist approach would result in bad policy.

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What Is Category Management?

Category management practices have become increasingly prevalent and important in retailing over the past ten years. The specifics can vary widely from retailer to retailer, but the term essentially describes a system in which all the products in a given product category are dealt with as a whole rather than on a brand-by-brand, package-by-package, or SKU-by-SKU basis. The FTC explained in its *Report on Slotting Allowances* that, "[a]s the name suggests, category management is an organizational approach in which the management of a retail establishment is broken down into categories of like products. Under category management, decisions about product selection, placement, promotion and pricing are made on a category-by-category basis with an eye to maximizing the profit of the category as a whole." Federal Trade Comm'n, Staff Report on the FTC Workshop on Slotting Allowances (Feb. 2001), *available at* http://www.ftc.gov/bc/slotting/index.htm (*FTC Report*).

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A retailer will typically select one supplier in that category—sometimes called the "category captain"—to take the lead role in helping the retailer implement a product management program. The captain then assumes some level of responsibility, subject to the retailer's approval, for the merchandising of that aisle or portion of the store. The captain provides the retailer with overall sales and trend data, usually from Nielsen or IRI, expert planning, and merchandising advice, and suggests retail shelf space allotments through a "plan-o-gram." It will also typically provide recommendations on packaging assortments, product additions or deletions, promotion types, promotion schedules, and possibly also retail prices. The retailer's goal is to get the best, most experienced advice available on how to compete most effectively and how to satisfy its consumers. These recommendations will necessarily cover not just the captain's own products but those of competitors as well. But the captain only recommends. The ultimate decision rests with the retailer. No retailer is going to delegate its operational control, profit mandates, or competitive market position to a third party. And, as the FTC summarized, "[t]he exact function performed by category captains varies widely across firms and product categories." *FTC Report* at 48.

Potential cost savings and informational advantages for retailers are considerable. One of the main advantages from the retailer's point of view is that "[t]he manufacturer may know things like the times of year when a product will sell best, the kinds of promotions that are most effective in moving the product, or the kinds of complementary goods that might be advantageously displayed in adjacent space." *Id.* As the leading business book on category management explains: "Retailers . . . rely on [the manufacturer] partner for information, expertise and resources in the development of plans." 3 R. Blattberg & E. Fox, Category Management: The Category Plan 15 (1995).

In its report, the FTC noted, "Category management can provide significant benefits to manufacturers, retailers, and consumers." *FTC Report* at 48. Among other things, it reduces retail costs by shifting part of the merchandising costs back to the supplier; it provides the retailer with more and better access to information; and ultimately it helps the retailer generate more sales and profits per square foot of space. Category management can also generate healthy competition among suppliers by adding another dimension on which that competition takes place—that is, the competition to be the category manager.

The FTC added, however, that category management "can also provide an opportunity for 'mischief,' particularly when it is practiced with a heavy reliance on a category captain." *Id.* at 49. The *FTC Report* identified four possible ways in which category management could lessen competition: (1) by placing in the hands of the category captain confidential information about rivals' plans; (2) by hindering the expansion of rivals; (3) by promoting collusion among retailers; and (i4) by facilitating collusion among manufacturers. *Id.* at 50. The *Conwood* decision focused on a particular instance of the second type of mischief: the use of the captain to provide false data on competitor's sales. *Conwood Co. v. U.S. Tobacco Co.*, 290 F.3d 768 (6th Cir. 2002), *cert. denied*, 123 S. Ct. 876 (2003).

Category management is ubiquitous in retailing, affecting most product categories and, by some estimates, 75 percent of supermarkets and over 50 percent of drug and department stores. CHAIN STORE AGE/KPMG NINTH ANNUAL SURVEY OF INVENTORY MANAGEMENT (Dec. 2001). But the heart of any category management relationship is the relationship between a single supplier and a single retailer. From an antitrust point of view, therefore, it is critical to resolve the question of how that relationship should be treated.

Should Discussions Between a Supplier and a Retailer Be Considered Horizontal?

As noted above, a few commentators have recently argued that when a supplier and a customer discuss competing products, those discussions should be viewed as horizontal under the antitrust laws. Thus, for example, in a recent speech, Federal Trade Commissioner Thomas Leary said that, while it may not be inappropriate for a supplier and retailer to discuss the supplier's own products, discussions between them regarding the products of *other* suppliers are problematic and in fact should be viewed as horizontal. As he explained:

> Some insist that category management should be analyzed as a vertical restraint, presumably because category managers are primarily suppliers to, not competitors of, the retail customers they advise. I believe the matter is more complex. In my view, the nature and context of the communications should control, not the formal relationship between the parties. In short, advice on the resale of the manufacturer's own product should be viewed as vertical; advice on the resale of a competitor's product should be viewed as horizontal.

Thomas Leary, A Second Look at Category Management 2–3 (May 17, 2004), *available at* http://www.ftc.gov/speeches/leary/040519categorymgmt.pdf. At least two other prominent commentators have warned against such communications—a warning that seems to suggest a belief that the relationship is horizontal. *See* Antitrust and Category Captains Roundtable Discussion, a Report by Gabrielle Herderschee-Hunter, *available at* http://www.antitrustinstitute.org/recent2/270.pdf (June 23, 2003) at 35 (remarks of Chris MacAvoy); and at 44 (remarks of Irving Scher) (*Roundtable Report*).

Commissioner Leary articulates the rationale for this position by reasoning that, while a manufacturer has a legitimate interest in the distribution of its own product, it lacks a legitimate interest with respect to competitive products. Thus, he states, "[a]ny advice that the captain gives to a customer about the appropriate ways to distribute a competitor's product is not likely to serve a legitimate interest, but rather affects horizontal competition and serves a horizontal interest. It should be viewed as a horizontal communication." Leary, *supra*, at 3. In support, he states that he is drawing on the so-called dual distribution cases, which he characterizes as "emphasiz[ing] whether the restraint in question serves a vertical or a horizontal interest." *Id.* As Commissioner Leary recognizes, the initial characterization as horizontal or vertical is often outcome-determinative. *Id.* at 2, 5 It therefore is a matter of no small moment whether his characterization is right or wrong.

Antitrust Case Law and Policy

The horizontalist approach is hard to square with the modern cases. If it is correct, literally thousands of daily discussions between suppliers and retailers would be cast into the horizontal net. Commissioner Leary invokes the post-*Sylvania* law of vertical restraints in support of his position.

But that body of cases, from *Sylvania* and *Monsanto* through *Sharp* and *NYNEX*, far from supporting his position, demonstrates precisely why supplier-retailer communications should not be treated as horizontal, even if the subject of those communications is other suppliers.

Antitrust law has long recognized the critical difference between horizontal and vertical arrangements. *See generally Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36 (1977). It runs through antitrust law like a major fault line (along with, for example, the distinction between unilateral and concerted conduct). The distinction is critical because, while we have reason to be generally suspicious of competitors working and communicating with each other (except in a very narrowly circumscribed set of circumstances, such as legitimate joint ventures and petitioning conduct), we have no such concerns about interactions between firms in a vertical relationship with each other. *See, e.g., Business Electronics Corp. v. Sharp Electronics*, 485 U.S. 717, 724–30 (1988). These interactions are and ought to be ubiquitous, and are fundamental to legitimate commerce. Vertical agreements thus cannot be viewed with the same jaundiced eye as are horizontal agreements.

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But what is "vertical" and what is "horizontal"? The horizontalist position is that an agreement between a manufacturer and a retailer with regard to other people's products is horizontal. This is wrong. The Supreme Court has been clear that the the horizontal/vertical distinction depends on the relationship between the parties reaching the agreement, not on the subject of the agreement being reached or its effects in the marketplace. "Restraints imposed by agreements between competitors have traditionally been denominated as horizontal restraints, and those imposed by agreement between firms at different levels of distribution as vertical restraints." *Sharp*, 485 U.S. at 730. Discussion between a supplier and a retailer is discussion between firms at different levels of the marketplace, and therefore any agreements relating to the relationship between them are necessarily vertical under the *Sharp* definition.

The distinction is not just a matter of labels. Antitrust policy rightly is suspicious of communications among competitors, and treats agreements among them harshly absent some demonstrable integration or other efficiency. Communications among firms whose primary relationship is one of customer and supplier, however, are fundamentally different. As the post-*Sylvania* cases recognize, manufacturers and their distributors must be in constant communication with each other as a matter of business necessity, and a rule of law that attached negative consequences to those communications would inevitably involve large losses in economic efficiency.

As the Court put it in *Monsanto*: "A manufacturer and its distributors have legitimate reasons to exchange information about the prices and the reception of their products in the market." *Monsanto Co. vs. Spray-Rite Service Corp.*, 465 U.S. 752, 762 (1984). A rule under which certain types of discussions between a manufacturer and a retailer are treated as horizontal would have an undesirable chilling effect on such communications. The business objectives of these parties are fundamentally complementary, and not adversarial. The retailer competes in a relevant market distinct from that in which the supplier competes. Its objective is to meet its consumers' needs by creating the best product array at the best prices; if it does not, it will lose customers to competing retailers. Whatever the supplier's interests, the retailer must do what is necessary to meet its customer's desires to remain competitive at its level of the market. All of its decisions—pricing and otherwise—must take that competition into account.

Commissioner Leary's assertion that the horizontal-vertical distinction should turn on the "nature and context of the communications" and whether there is an "effect on horizontal competition" is the precise argument advanced by Justice Stevens's *Sharp* dissent. The *Sharp* majority, however, specifically rejected the argument, holding that the distinction was between "agreement[s] between competitors" as horizontal, and "agreement[s] between firms at different levels of distribution" as vertical. 485 U.S. at 730. Every antitrust issue of consequence involves horizontal competition. If horizontal competition is not affected, no further analysis need be done.[1]

Interbrand vs. Intraband Competition

Commissioner Leary argues that the "permissiveness [of *Sylvania*], extends only to activities that are designed to rationalize *intrabrand* competition at the retail level. To the extent that the manufacturer attempts to rationalize *interbrand* competition at that level, it is directly affecting horizontal competition and the activity should be analyzed as a horizontal restraint." Not so.

The distinction between interbrand and intrabrand competition is of course an important one in antitrust law, but it is not the same as the horizontal/vertical distinction. Just because an agreement affects interbrand competition does not mean that the agreement is horizontal. If it did, then every exclusive dealing agreement would suddenly be horizontal—a troublesome proposition given the ubiquity of such agreements in our economy. In fact, such agreements are vertical even though they directly affect interbrand competition. This is the spirit if not the express holding of *NYNEX Corp. v. Discon, Inc.*, 525 U.S. 128 (1998), where the Court ruled that an agreement between a customer and a supplier restricting the customer's freedom to deal with a competing supplier should not be treated as a horizontal group boycott. If the rule were otherwise, every exclusive dealing agreement in which a retailer agrees to devote its sales efforts to a particular brand or manufacturer would be per se unlawful. The rule of reason is the proper method for analyzing such agreements, but that would change if Commissioner Leary's horizontal characterization were adopted.

Even when a retailer does something that adversely affects one of its suppliers, it is doing so to better compete at the retail level. After all, every retailer but the rarest is constrained by competition at its level of the market.

It appears that some of the hostility to category management may be based on the notion that such arrangements represent a sharp break from the past. Thus, for example, one of the speakers at the American Antitrust Institute Roundtable is reported to have said: "Never before in retail history have manufacturers advised retailers on what to do with their rivals' products." *Roundtable Report*, *supra*, at 28. But that can't be right. While some new concepts and business techniques may be at work in category management, the basic business relationship is not fundamentally new. Manufacturers have been telling retailers what they should do with their rivals' products (sometimes in colorful language!) from time immemorial. There is nothing new about a supplier and a retailer discussing whether the retailer should carry the products of other manufacturers and to what extent. Indeed, a salesperson would only be doing half of his job if he ignored his competition in a sales call. Again, think of exclusive dealing agreements, which are simply agreements

[1] Nor is accurate to say, as Commissioner Leary appears to be suggesting, that the dual-distribution cases lend the horizontalists any support. In cases decided after *Sylvania*, the courts have held consistently either that the relationship between a self-distributing manufacturer and its other distributors is vertical or that such relationships should be judged under the rule of reason, which amounts to the same thing. *See, e.g.*, Electronics Communications Corp. v. Toshiba Am., 129 F.3d 240, 244 (2d Cir. 1997); Illinois Corporate Travel v. American Airlines, 889 F.2d 751, 753 (7th Cir. 1989); Krehl v. Baskin Robbins Ice Cream Co., 664 F.2d 1348, 1354–47 (9th Cir. 1982); Beyer Farms v. Elmhurst Dairy, Inc., 142 F. Supp. 2d 296, 302 (E.D.N.Y. 2001); 8 Phillip Areeda & Herbert Hovenkamp, Antitrust Law ¶ 1605 (1989); 12 *id.* ¶ 2033 (1999); ABA Antitrust Section, Antitrust Law Developments 160–61 & nn. 896–97 (5th ed. 2002); *see also* Sewell Plastics v. Coca-Cola Co., 720 F. Supp. 1186, 1192 (W.D.N.C. 1988) (per se rule applicable only where firms are competitors for all relevant purposes), *summary judgment entered*, 720 F. Supp. 1196 (W.D.N.C. 1989), *aff'd*, 1990-2 Trade Cas. (CCH) ¶ 69,165 (4th Cir. 1990).

between a supplier and a customer regarding other products. Exclusive dealing is not a recent phenomenon. *See, e.g., Standard Fashion Co. v. Magrane-Houston Co.*, 258 U.S. 346 (1922).

To subject category management to blanket condemnation would be to require retailers to operate in isolation from their potentially best advisors. It is essential that retailers have full access to such expert advice in order for them to compete against their fellow retailers.

The horizontalist position appears to be based on the premise that decisions are made by the supplier, as if the retailer has no role in its own market success. But that is not the reality. The retailer has its own principals and constituencies that it must satisfy on a daily basis—shareholders, employees, customers—that are entirely independent of the supplier and its desires to compete against its competitors. The retailer ignores these at its own peril.

What about a situation in which a retailer owns a supplier (i.e., has a private label which it sells on its shelves). In that case, should discussions between a supplier and retailer regarding that retailer's private label product be considered "horizontal"? At least one commentator has suggested so.[2] The answer is still no. Unless the retailer is actually marketing that private label to other retailers—an unusual if not non-existent circumstance—then that retailer is no more a competitor of the supplier than a retailer without a private label. Yes, in some sense the private label product competes with the supplier's branded product on the store's shelves, but the price of both is set by the same retailer (perhaps with advice sought from the category expert supplier). There is no more competition between the supplier's brand and the private label product than there is between that brand and a third supplier's brand, or between two brands owned by the same supplier.

Obviously if two suppliers (or two retailers) are misusing a category management relationship to coordinate with each other, that should be treated as horizontal. But that is not the horizontalists' point. Those are real horizontal relationships and deserve to be treated as such. The horizontalists are trying to convert what is properly viewed as a vertical one into a horizontal one.

Conclusion

While category management practices have been in use for a decade, the debate over the application of the Sherman Act to such practices appears to be gaining momentum. There should be no debate, however, about whether the relationship between a retailer and a supplier is horizontal. The business reality is that this is a vertical relationship, the terms of which will be properly constrained by competitive forces in the distinct markets in which the parties independently compete. ●

[2] *See* Robert A. Skitol, *Consolidation and the Private Label Sector: Antitrust Enforcement Policy Developments* 20 (Oct. 1, 2002), *available at* http://www.antitrustinstitute.org/recent2/207.pdf ("To the extent that a brand manufacturer in its role as category captain persuades its retail partners to abandon their plans to price or promote private label goods aggressively against the branded products, or there is any coordination of the plans in these areas, the parties could easily be found to be engaged in illegal collusion.").